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Different Approaches for Addressing Program Solvency

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The Honorable William V. Roth, Jr.
Chairman
The Honorable Daniel Patrick Moynihan
Ranking Minority Member
Committee on Finance
United States Senate

The Social Security program has successfully provided support for our nation's elderly and disabled populations for nearly 60 years. However, it is expected that the program will face a financing shortfall in the future as the baby boom generation retires. Numerous groups have studied the problem and are recommending solutions. Some of the proposals involve adjustments to the provisions of the existing program, while others discuss more fundamental structural reform of the program. This report provides an overview of the financing problem and examines the different approaches that are being advanced to address the program's future solvency.

As agreed with your offices, unless you release its contents earlier, we plan no further distribution of this report for 30 days. At that time, we will make copies available to the Commissioner of Social Security; relevant congressional committees and subcommittees; and to others, on request.

This report was prepared under my direction. Please contact Barbara D. Bovbjerg, Associate Director, at (202) 512-7215 if you have any questions. Other major contributors to this report are listed in appendix IV.

Cynthia M. Fagnoni
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Executive Summary

Purpose

The aging of the "baby boom" generation, lower fertility rates, and increasing longevity have eroded the long-term solvency of the Social Security program.[1] The system's annual cash surpluses are currently projected to decline substantially beginning around 2008, and by 2013 benefit payments are expected to exceed cash revenues. The Social Security Trust Funds are forecast to be depleted by 2032, and from that point on revenues are expected to be sufficient to pay no more than 75 percent of promised benefits. While the financing problem is not immediate, analysts agree that it should be addressed soon to mitigate the impacts of whatever means are chosen to correct it by spreading them out over a longer period and allowing participants more time to adjust.

A national debate is now under way to identify how best to solve Social Security's long-term financing problem. To increase congressional and public understanding of the issues related to Social Security financing, the Senate Finance Committee asked GAO to discuss (1) the various perspectives that underlie the current solvency debate, (2) the reform options within the current program structure, and (3) the issues that might arise if Social Security were restructured to include individual retirement accounts. This report also discusses the likely impacts on national saving of reform proposals that call for changes in how Social Security benefits are funded.

Background

The Social Security program was enacted in 1935 in response to the economic deprivations of the Depression. Originally created as a benefit system for retired workers, over time Social Security has been expanded to insure disabled workers and the families of retired, disabled, and deceased workers. Today, Social Security provides income support to 44 million retired and disabled workers and to the dependents and survivors of covered beneficiaries. Since Social Security's creation, poverty rates for the elderly have fallen from an estimated 50 percent in 1935 to 11 percent today.

Social Security's pay-as-you-go financing structure was adopted to keep the federal government from building up large cash reserves.[2] There were concerns that doing so could prolong the Depression, and there was also a desire to alleviate the financial plight of the elderly as soon as possible.

[1]In this report, "Social Security" refers to the Old-Age, Survivors, and Disability Insurance (OASDI) program.

[2]Under a pay-as-you-go financing structure, payments to current beneficiaries come from payroll taxes paid by current employees.

Given the high ratio of workers to eligible recipients, it was possible to give the earliest retirees relatively large benefits, as compared with their contributions, and the benefits were able to have a measurable impact on the recipients' financial well-being. The program's creators foresaw the need for increased revenues as the system matured, and legislative actions over the years have maintained its solvency. In the future, financing will be more difficult because more people will be living longer and relatively fewer workers will be supporting them. Over the next 75 years, Social Security's total shortfall is projected to be about $3 trillion in 1997 dollars.

In early 1997, the Advisory Council on Social Security reported on the program's long-term financing problem. While the Council members generally agreed on the size of the problem, they could not reach a consensus on how to resolve it. Instead, three packages of proposals were advanced by different groups of Council members. One package consisted largely of revenue enhancements and benefit changes but did not recommend fundamental changes to the structure of the existing program. In contrast, the other two packages, while also incorporating adjustments to the current program, called for a degree of "privatization" through the creation of mandatory individual accounts. A number of other proposals to address Social Security's long-term financing problem have been advanced by various research organizations, academics, and members of the Congress. For the most part, these other proposals contain provisions similar to those found in the Advisory Council's report.

Results in Brief

The need to ensure long-term solvency drives the current Social Security debate. Many options exist for restoring long-term solvency within the current program structure. These possibilities include raising the retirement age, altering the benefit formula, reducing the cost-of-living adjustment (COLA), investing Trust Fund surpluses in the stock market, and mandating participation of workers who are currently excluded. Some combination of these changes could restore program solvency while retaining the program's social insurance features. While these options generally require reducing benefits or raising revenues, their effects on workers and retirees might be mitigated if the adjustments were made sooner rather than later.

Proposals for more fundamental program changes, featuring the creation of individually owned retirement accounts, have the potential to increase returns overall but would entail increased risk for individuals—risk now borne by the government. Indeed, moving even part of Social Security to

individual accounts would require careful consideration of the issues raised by such a fundamental change. Further, the consequences for the insurance aspects of the current Social Security system—disability insurance and survivor/dependent benefits—would require close scrutiny if Social Security were wholly or partly privatized. Individual accounts also raise issues such as how benefits would vary among individuals and groups at greater risk of falling into poverty, how to finance any transition costs, and how best to administer such plans.

Most of the reform proposals envision substituting, to some extent, advance funding for the largely pay-as-you-go system that exists today. In principle, advance funding of Social Security benefits could lead to an increase in national saving. Increased saving, in turn, could lead to higher rates of economic growth and better enable future generations to support themselves and future retirees. However, moving to an advance funded system would entail substantial transition costs that could offset any potential savings, at least for a number of years.

Over the years, Social Security has evolved to be more than a retirement program. Social Security today not only provides the floor for an adequate retirement income, it also insures families in the event of the death or disability of the earner and helps provide retirement income security for low-income workers. Restoring the system to financial solvency will require fundamental choices about such issues as the strength of guarantees of retirement income to the nation's elderly, levels of insurance for working families, and the role of government in providing retirement income. Because such decisions will affect the nation and its economy for years to come, they should be made with full knowledge and debate of the trade-offs inherent in each proposed change.

GAO's Analysis

Fundamental Differences Underlie Reform Proposals

Supporters of changes within the existing system cite the need for a "social insurance" approach, whereby workers participate collectively, through the federal government, in a program that pools risks arising from the loss of earnings caused by retirement, disability, or death. Such reforms would thus preserve the long-standing structure of Social Security.

Alternative approaches to reform largely focus on strengthening individual choice and responsibility. Supporters of these approaches argue for a greater emphasis on linking returns to contributions and for separating the retirement income purpose from the social insurance goal. Advocates of this "annuity-welfare" approach emphasize providing retirement income through private institutions (that is, privatization) and support a more limited government role in providing a basic level of support. Reforms they support incorporate individual accounts, which, they argue, offer the possibility of higher returns on contributions and improvements in national saving.

Options Exist for Restoring Solvency Within the Existing Program Structure

Social Security's future financing problem could be resolved within its existing structure by increasing revenues, reducing benefits, or some combination of the two. Options that would increase revenues include raising the payroll tax, extending coverage to currently excluded workers, increasing the maximum taxable earnings level, increasing the income tax on benefits, and investing the Trust Funds in higher-earning assets. Options for reducing expenditures include reducing or eliminating benefits for certain groups of retired workers, survivors, dependents, or disabled workers; increasing the normal or early retirement age; and limiting COLA increases. The impact from any one of these options on the long-term actuarial deficit would depend on the extent to which the option was implemented. Although changes such as these would retain both the social insurance and redistributive aspects of the current system, all except changing the Trust Funds' investment policy could directly and negatively affect the economic well-being of groups of workers or beneficiaries. The results from these changes would be less severe if they were spread out over a number of years. However, some analysts express concern that ongoing demographic trends will continue to affect the program, requiring additional adjustments in the future.

Individual Accounts Are an Option to Restructure the Program

Other proposals would alter the system more fundamentally to restore solvency. These proposals have in common the advance funding of future benefits (as opposed to the pay-as-you-go approach) through the creation of individual accounts. System participants would own and, to varying extents, manage their own individual accounts, whose returns would provide some or much of these contributors' future retirement income. Some proposals would finance these accounts with new or increased taxes, while others would shift some portion of current Social Security taxes to this purpose. Most such proposals retain some features of the

current system. Advocates of individual accounts point to the potential for increased returns for participants, although others have raised concerns that the risks of investing would be borne by each individual rather than collectively by the government.

While individual accounts offer the potential of higher retirement incomes through investing in stocks and bonds, important concerns surround such proposals. The primary concern is risk. There is a much greater potential for significant deterioration of an individual's retirement "nest egg" under a system of individual accounts. Not only would individuals bear the risk that market returns would fall overall but also that their own investments would perform poorly even if the market, as a whole, did well. Further, shifting to individual accounts could disadvantage certain groups. Women, for example, have historically earned less and tended to invest more conservatively than men and so would likely receive less, on average, than men from their individual accounts.

Other issues also must be addressed, including what level of basic benefits would continue to protect those without adequate resources, how the existing disability and ancillary benefits provided through Social Security would be treated, how other sources of retirement income might be affected, how much the accounts would cost, whether and how the accounts would be annuitized, and whether the accounts would be administered publicly or privately. Such issues would need to be addressed before implementing a system incorporating individual accounts.

Raising National Saving Could Help Alleviate the Burden of Retirement Costs

A larger economy in the future would help ease the burden of meeting retirement costs while sustaining a rising standard of living. Thus, Social Security reforms that promote increased national saving while restoring solvency would advance complementary national goals. For example, reform proposals that involve advance funding of future benefits could raise saving if they were not offset by additional public borrowing or additional spending. However, changing the manner in which current Social Security funds are invested, whether publicly or privately, might not, by itself, increase saving. For example, while shifting current Trust Fund surpluses to the stock market or to individual accounts could potentially raise overall returns, it would represent an asset shuffle rather than new saving. Currently, the Treasury uses the Social Security surpluses to finance other government activities. If the government had to

borrow to replace the lost surplus funds, no net increase in national saving would occur.

Efforts to increase advance funding are complicated, because explicitly recognizing and funding some or all of the $9 trillion in the program's unfunded promised benefits could require some generations of workers to "pay twice"—once to cover the already-accrued benefits of current retirees and again to advance fund their own retirement benefits. To the extent that advance funding requires such transition costs, the positive effects on saving are postponed well into the future. Moreover, raising saving, while an important national goal, should not, by itself, determine the approach to restoring the solvency of the Social Security program.

Agency Comments

GAO obtained comments on a draft of this report from the Social Security Administration (SSA) and from several subject matter experts. SSA generally agreed with GAO's treatment of the issues and offered a number of technical comments. The subject matter experts also offered technical comments. GAO made changes throughout the report to respond to these comments, as appropriate.

Contents

Abbreviations

AIME	average indexed monthly earnings
COLA	cost-of-living adjustment
DI	Disability Insurance
EBRI	Employee Benefit Research Institute
ERA	early retirement age
ERISA	Employee Retirement Income Security Act
GPO	government pension offset
HI	Hospital Insurance
IA	individual account
IRA	individual retirement account
MB	maintain benefits
NRA	normal retirement age
OASDI	Old-Age, Survivors, and Disability Insurance
OASI	Old-Age and Survivors Insurance
PIA	primary insurance amount
PSA	personal security account
SSA	Social Security Administration
SSI	Supplemental Security Income
TSP	Thrift Savings Plan
WEP	windfall elimination provision

Introduction

The Social Security program is the foundation of the nation's retirement income system. Since 1940, Social Security has been providing benefits to the nation's eligible retired workers and their dependents. In addition to retired worker benefits, Social Security also provides protection for covered workers with severe disabilities and their dependents. Also, spouses and children of deceased workers may receive Social Security survivor benefits. The program is financed largely on a pay-as-you-go basis, with payroll taxes from today's workers paying the benefits of today's beneficiaries.

Demographic trends indicate that the Social Security program will begin to experience a long-term financing problem after about 2013, when benefit payments will start exceeding cash revenues. The aging baby boom generation will be followed by a relatively smaller work force that will have to support a relatively larger group of retirees. This trend, combined with the increasing longevity of the elderly, will significantly drive up the costs of maintaining the program. Without action to raise program revenues or cut program spending, the Social Security Trust Funds will be exhausted by 2032.

Proposals being considered for resolving the future solvency problem range from making adjustments to the tax and benefit structure of the current program to introducing features such as individual accounts that could substantially alter the existing program structure. Despite these differences, policymakers and Social Security experts agree that taking action soon is desirable to alleviate impacts on workers and beneficiaries.

The Social Security Program

About 44 million people receive Social Security benefits today, and about 147 million covered workers pay Social Security payroll taxes. More than 40 percent of the cash income of those aged 65 and older comes from Social Security benefits, and over 60 percent of this population receives at least half their income from Social Security benefits. For 15 percent of this population, Social Security benefits are the only source of cash income. The Social Security program is one reason that poverty rates among the nation's elderly have fallen dramatically—an estimated 39 percentage points since 1935.[3]

Revenue Structure

Social Security revenues come from three main sources: (1) payroll taxes of 12.4 percent on covered earnings (up to $68,400 in 1998) split equally

[3]In 1996, the poverty thresholds were $7,525 for an aged individual and $9,491 for an aged couple.

between employees and their employers and paid in full by the self-employed,[4] (2) income taxes on up to one-half an individual's or couple's Social Security benefits when total income exceeds certain thresholds,[5] and (3) interest earnings on U.S. Treasury securities held by the Trust Funds.

Program revenues in 1997 totaled $457.7 billion, of which almost 90 percent came from payroll taxes, about 1.7 percent from the income taxation of Social Security benefits, and 10 percent from interest on the Trust Funds' assets. The share coming from the income taxation of benefits is expected to grow because the income thresholds at which benefits become taxable are not indexed. The portion coming from interest on the Trust Funds will increase until about 2020 and then fall dramatically as the Trust Funds redeem securities to help pay benefits.

Benefit Structure

Social Security's benefit structure has evolved and expanded considerably over time. Under the original 1935 Social Security Act, only retired workers meeting specified conditions were eligible for monthly benefits. Benefits under the original act had a strong "individual equity" component—that is, individual benefits were positively related to lifetime earnings. Benefits also contained a "social adequacy" component—that is, they were proportionately larger, but absolutely smaller, for those with relatively low lifetime earnings. Currently, benefits are calculated using the 35 years of highest earnings, not total lifetime earnings, and benefits are provided to workers' spouses, children, and survivors, who may not have worked for pay. These changes improved the social adequacy component of the benefit structure. The appropriate balance between individual equity and social adequacy is a fundamental issue surrounding Social Security's benefit structure and reflects the extent to which the program redistributes income among workers and beneficiaries.

Auxiliary Benefits

Social Security was originally designed to provide benefits only to retired workers. Major expansions were made to the program in 1939, when the Congress provided "auxiliary" benefits for workers' eligible wives, children, and survivors. In 1956, it provided benefits for disabled workers and their eligible dependents. Other amendments to the act have extended benefits to husbands, widowers, divorced spouses, and mothers and fathers (spouses under age 65 with benefit-eligible children in their care).

[4]Payroll and income taxes paid by the self-employed are adjusted so they can receive the favorable income tax treatment given employers for their payroll tax contributions.

[5]Up to 85 percent of Social Security benefits can be subject to the income tax. Some of this income tax revenue is dedicated to Medicare's Hospital Insurance (HI) Trust Fund.

Some beneficiaries are eligible to receive retired worker benefits on the basis of their own work record and are also eligible to receive a higher benefit on the basis of their current or former spouse's work record. Essentially, these beneficiaries, who are called "dually entitled," receive their own retired worker benefit and the difference between that and the higher auxiliary benefit. Table 1.1 shows the current benefit categories and the number of beneficiaries in each category.

Table 1.1: Social Security Benefit Types and Number of Beneficiaries Receiving Them in December 1996

Benefit type	Number of beneficiaries
Retired workers	**26,899,170**
Dually entitled	5,629,780
Not dually entitled	21,269,390
Disabled workers	**4,386,040**
Spouses	**3,194,950**
Of retired worker	2,971,650
Of disabled worker	223,300
Children	**3,811,600**
Of retired worker	442,010
Of disabled worker	1,467,490
Of deceased worker	1,902,100
Survivors	**5,445,710**
Widows and widowers	5,204,220
Mothers and fathers (with eligible children in their care)	241,490

Source: SSA.

Benefit Calculation

Calculating Social Security benefits is a three-step process. First, a worker's covered earnings over his or her 35 years of highest earnings are identified. Social Security uses average indexed monthly earnings (AIME) as its measure of these "lifetime" covered earnings.[6] Second, a progressive benefit formula is applied to these lifetime covered earnings to determine the benefit that will be payable to the worker at the normal retirement age

[6]The AIME is calculated by multiplying a worker's actual earnings in a given year before he or she attains age 60 by the ratio of the average national earnings level for the year he or she attains age 60 to the average national earnings level for the year being indexed. Earnings received after age 60 are not indexed but can be used in the benefit calculation formula. The total amount earned during the 35 years of highest indexed earnings is divided by 420 (35 years x 12 months/year) to arrive at the AIME.

(NRA), currently age 65.[7] This NRA benefit, or primary insurance amount (PIA), is the basic amount used to determine the actual benefit for those receiving benefits on the basis of a worker's earnings record. Finally, the benefit is adjusted for the age at which the beneficiary first receives the benefit.[8]

Auxiliary benefits are based on the worker's PIA. The benefits for dually entitled people are based on their own PIAs. If the spouse or widow(er)'s benefit is higher, the dually entitled person's benefit is supplemented to raise it to the amount of the spouse or widow(er)'s benefit.

Benefit Indexing

Currently, automatic benefit indexing provisions generally increase the worker's PIA by an annual COLA.[9] The COLA is equal to the rise in the consumer price index over a congressionally established period of a year. Indexing allows Social Security benefits to maintain the same purchasing power over the beneficiary's retirement. Retirement income from most other sources is not fully indexed and thus tends to decline in real terms over time.

Financing Structure

Social Security is financed largely on a pay-as-you-go basis. Under this type of financing structure, the payroll tax revenues collected from today's workers are used to pay the benefits of today's beneficiaries. Under a strict pay-as-you-go financing system, any excess of revenues over expenditures is credited to the program's trust funds, which function as a contingency reserve.[10] Social Security's Trust Funds reserve allows the

[7]The benefit formula is progressive in that it replaces a relatively larger portion of lifetime earnings for people with low earnings than for people with high earnings. According to SSA, workers with low lifetime covered earnings will have benefits that replace approximately 56 percent of their AIME, workers with average lifetime covered earnings will have about 42 percent replaced, and workers with lifetime covered earnings at or above the maximum taxable level will have only about 28 percent replaced. The NRA benefit, or "primary insurance amount," equals 90 percent of AIME up to the first threshold + 32 percent of AIME between the first and second thresholds + 15 percent of AIME above the second threshold. The thresholds are wage-adjusted and set yearly. For 1998, the first threshold is $477 and the second is $2,875. The thresholds apply to those attaining age 62 (or becoming disabled or dying) in a given calendar year, regardless of their age when benefits are first received.

[8]To ensure roughly comparable expected lifetime benefits regardless of the age when benefits are first taken, benefits are actuarially reduced if first taken before the NRA and increased if first taken between the month one attains the NRA and the month one attains age 70. Benefits are also reduced if postretirement earnings exceed certain thresholds.

[9]The COLA is payable for each year that has passed since the worker first became eligible for benefits (age 62 for retired worker beneficiaries). Thus, someone who waits until age 65 to claim retired worker benefits will use the benefit formula in place when he or she was age 62, and his or her PIA will be increased by the total of all COLAs provided beginning with the year he or she became 62.

[10]Annual program revenues currently exceed annual program expenditures, resulting in partial advance funding of the program. Thus, Social Security is not strictly a pay-as-you-go program, and the Trust Funds are not simply a contingency reserve.

government to manage the inevitable differences over time between revenues and expenditures.

One reason the pay-as-you-go approach was initially used is that it required relatively small contributions at a time when the program was young and benefit payments were small. However, this structure required increasing contribution levels as the program matured and more beneficiaries with higher average benefits were added to the beneficiary rolls. In addition, the pay-as-you-go structure leaves the program and the federal government susceptible to financing problems when costs increase more than expected or revenues fail to meet expected levels, such as might occur with changing short-term economic conditions. Every year, Social Security's Board of Trustees estimates the financial status of the program for the next 75 years using three sets of economic and demographic assumptions about the future.[11] According to the intermediate set of these assumptions, the nation's Social Security program will face solvency problems in the years ahead unless corrective actions are taken.

Social Security Faces a Long-Term Financing Problem

The Social Security program is not in long-term actuarial balance. That is, Social Security revenues are not expected to be sufficient to pay all benefit obligations from 1998 to 2072. Without changing the current program, excess cash revenues from payroll and income taxes are expected to begin to decline substantially around 2008. By 2013—15 years from now—these cash revenues will be insufficient to pay all program costs.[12] After 2013, Social Security will have to start redeeming some of its assets to obtain the cash needed to pay benefits. The Trust Funds are expected to be exhausted in 2032.

The anticipated revenue shortfall over the next 75 years is estimated at $3 trillion, or an average annual shortfall of $40 billion (in 1997 dollars). This $3 trillion shortfall is based on the assumption that the Social Security program will continue under its current structure. That is, new workers will enter the system, pay payroll taxes (which will be matched by their

[11]The 75-year projection period was established as an indicator of whether the system would have sufficient resources to provide benefits over the lifetime of a worker. The Trustees make three sets of projections: one using a high-cost (pessimistic) set of assumptions, one an intermediate-cost set, and one a low-cost (optimistic) set. We have used the intermediate cost projections as the basis of our analysis. Unless otherwise indicated, we refer to the estimates for the 75-year period from 1998 to 2072 (see The 1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds [Washington, D.C.: U.S. Government Printing Office, 1998]).

[12]About 98 percent of program costs are for benefit expenditures.

employers), accrue benefit credits while working, and receive benefits when they retire.

Even if revenue or expenditure adjustments necessary to reach 75-year balance were achieved, the financing problem still might not be permanently resolved. For the foreseeable future, each new 75-year projection period will have a higher long-term financing shortfall than the last. For example, suppose the payroll tax was raised sufficiently to reach balance, and the current actuarial assumptions were realized for the period 1998 through 2072. Under this scenario, the Trust Funds would have only about 1 year's worth of benefits remaining in 2072. If the same actuarial assumptions continued to be used in each of the years between 1998 and 2072, the Trust Funds would continue to be expected to be exhausted shortly after 2072, but, beginning in 1999, the 75-year projections would show a long-term revenue shortfall for the program that would grow over time.

The program has another, higher revenue shortfall estimate—about $9 trillion, as of October 1, 1997. This is the amount of the program's unfunded benefit obligations—the accrued future benefit obligations that will not be able to be paid with assets currently in hand. A large unfunded liability in a government program financed primarily on a pay-as-you-go basis is generally not considered a problem because of the government's authority to tax current workers to pay current benefits. Thus, current unfunded liabilities are passed onto future generations. However, if the current Social Security program were ended or changed to an advance funded system, all $9 trillion of accrued benefit obligations would have to be paid if the government honored these obligations in full.

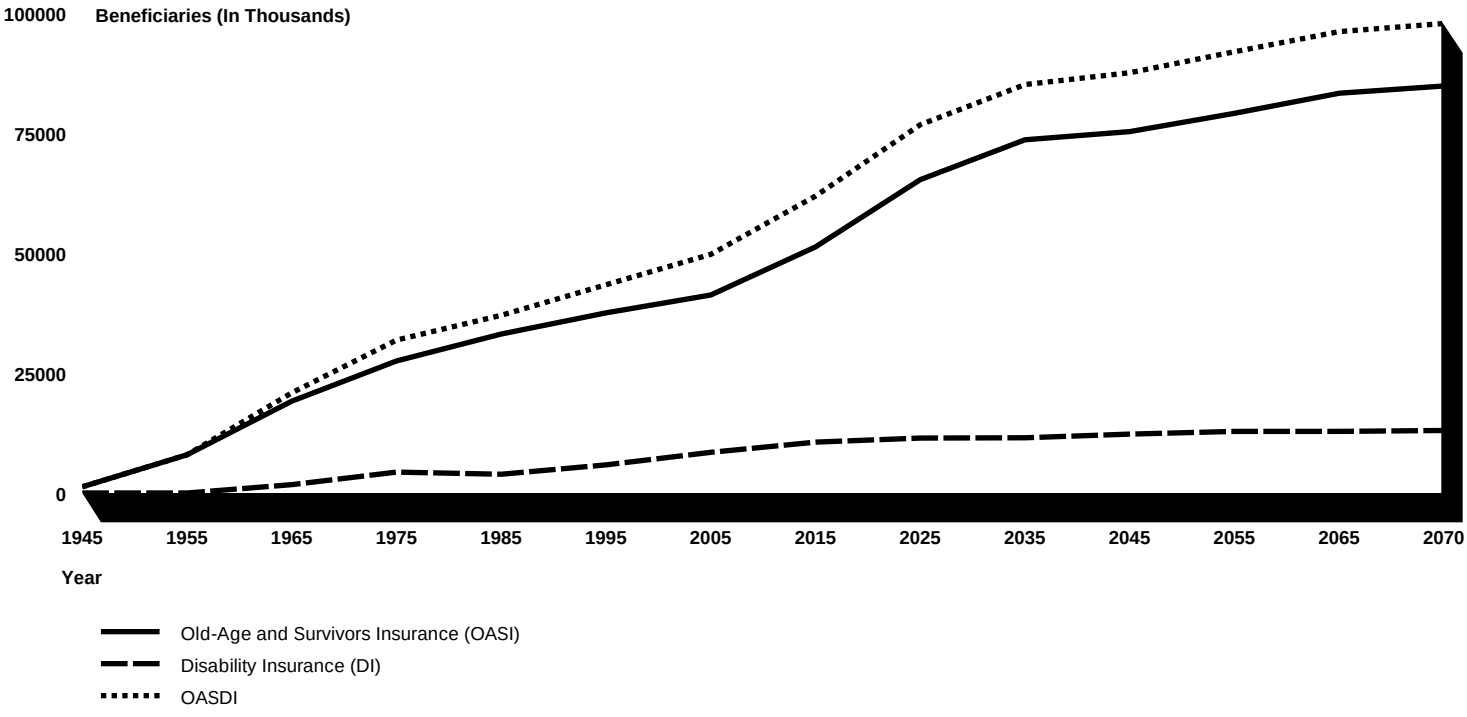
Social Security does not face an immediate financing crisis because its cash revenues are expected to exceed its expenditures until 2013. However, the substantial size of the anticipated 75-year shortfall ($3 trillion if the program remains a pay-as-you-go system and $9 trillion if it is terminated or becomes a system that is funded in advance) suggests the need for reform action in the near future. Social Security is currently building up some Trust Funds reserves, which can help offset some of the revenue shortfall after 2013. Interest earnings on and redemption of these reserves, along with payroll and income tax revenues, are expected to provide sufficient resources, under the Trustees' 1998 intermediate assumptions, to pay program obligations until about 2032. Without action to improve the system's financial outlook, the program is expected to have

revenues sufficient to cover only about 75 percent of anticipated benefit obligations in 2032, and this will decline to about 68 percent by 2072.

Demographic Changes Will Strain Social Security's Resources

An important factor affecting Social Security's pending financing problem is the rapidly approaching retirement of the baby boom generation. The oldest of this generation will reach early retirement age (62) in 2008, and the youngest will reach it in 2026. This large number of retirees would substantially increase program costs and strain the ability of the program to pay benefits even if it were the only factor affecting future costs. (See fig. 1.1.)

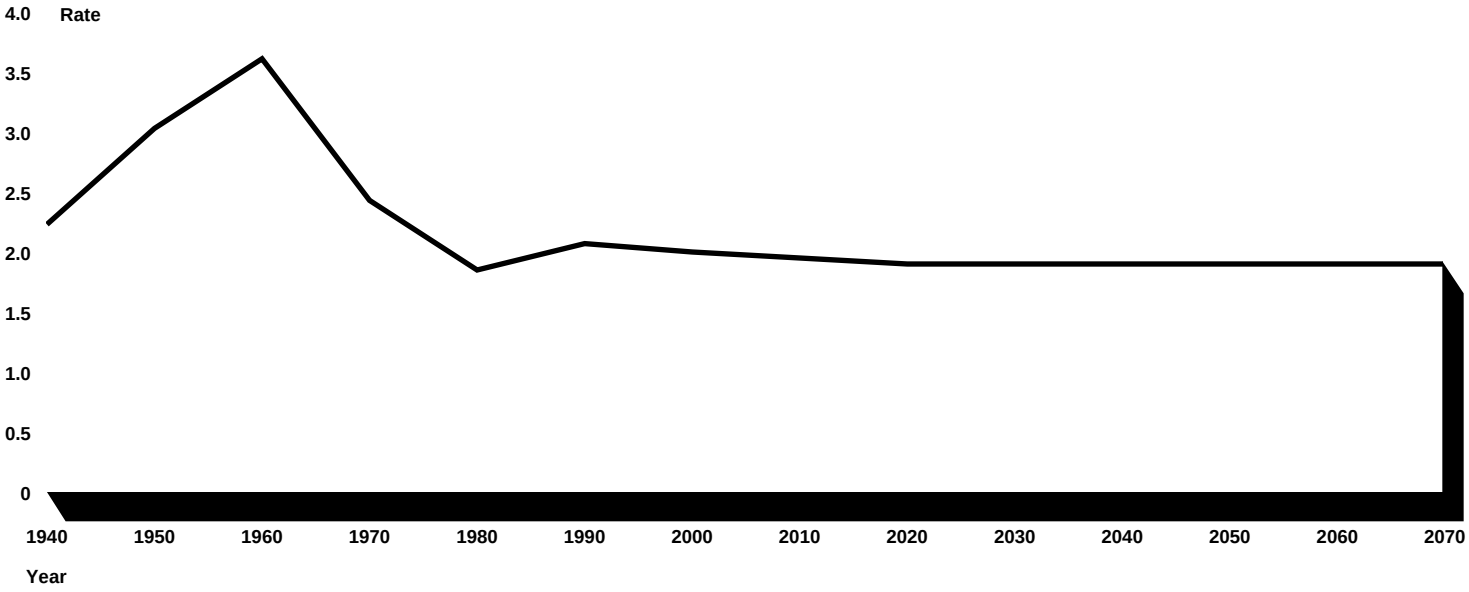
Figure 1.1: Historical and Projected Growth in the Number of Social Security Beneficiaries, 1945-2070



Source: 1998 Annual Report, Social Security Board of Trustees, 1998, Tables II.H12 and II.H43, pp. 156-57 and 162-63.

Exacerbating the problem of the retirement of the baby boom generation is the relatively smaller generation that follows it. The post-baby-boom generation, which resulted from the rapid decline in fertility rates from the mid-1960s to the mid-1980s (see fig. 1.2), will result in relatively fewer workers to support a larger number of retirees. The number of workers whose payroll taxes will support those on Social Security will fall from today's about 3.4 per beneficiary to an anticipated 2.0 per beneficiary in 2030.

Figure 1.2: Historical and Projected Fertility Rates, 1940-2070



Source: 1998 Annual Report, Social Security Board of Trustees, 1998, Table II.D2, pp. 60-61.

Another factor that will raise program costs is the increase in life expectancies. Life expectancy for 65-year-old men increased from 11.9 years at the program's inception to 15.3 years in 1995 and for 65-year-old women, from 13.4 years to 19.0 years. Life expectancies are expected to continue to increase to 18.7 years for men and 22.0 years for women in

2070. This increase will further strain the program's financing, requiring revenue increases or benefit cuts to keep the program solvent.[13]

Other Factors Can Affect Program Solvency

Other factors, primarily economic and behavioral aspects of Social Security's actuarial assumptions, can also affect its costs and revenues.[14] Factors that increase program costs include the following:

- automatic COLAs, which maintain the real purchasing power of benefits but increase both nominal benefit levels and program costs geometrically over time;
- the relaxed earnings test, which allows benefit-eligible workers to receive Social Security benefits even though they have considerable earnings;[15] and
- rising real wages, which increase real benefits over time.

Factors that constrain program revenues include the following:

- an earlier average retirement age, which reduces the period during which workers pay payroll taxes;[16]
- lower than expected rates of real economic growth, such as occur with recessions, which constrain the growth of covered wages and make paying taxes to support Social Security beneficiaries more onerous than if the economy had grown at a faster rate; and
- the growing share of total employee compensation that is not subject to payroll taxes.

Analysts Differ on Approaches to the Problem but Agree on the Need to Act Soon

The crucial role Social Security plays in providing income support to the nation's elderly and disabled populations makes the program an ongoing policy focus of the Congress and numerous nonfederal groups and organizations. In the past when financing problems have been encountered, the Congress has acted to alter the revenue and benefit provisions of the program to maintain its solvency. While the program has

[13]1998 Annual Report, Social Security Board of Trustees, 1998, Table II.D2, p. 60.

[14]The impacts of these factors would usually occur regardless of the program's financing structure.

[15]Because Social Security originally insured against a loss of all covered earnings by those 65 and older, an earnings test was instituted to ensure that such a loss had occurred before benefits were granted. The earnings test is discussed more fully in ch. 3.

[16]An earlier average retirement age also lengthens the time benefits are received. However, the program actuarially adjusts benefits received before the NRA, so this does not, on average, increase program costs.

been modified on an ongoing basis, major legislative reforms, such as those enacted in 1977 and 1983, have been made less frequently.

Because the Advisory Council could not reach consensus on how to fully restore solvency over the 75-year period, it brought forward three packages of proposals, including two that combine elements of individual accounts with other program changes, such as adjustments to the benefit formula.[17] One of the three Advisory Council proposals—the "maintain benefits" (MB) proposal—involves mainly traditional reforms[18] that would operate within the existing structure of the program. A second proposal would significantly change the system by creating individual retirement accounts—"personal security accounts" (PSA)—that would be privately managed and invested as directed by the individual worker. The third proposal—"individual accounts" (IA)—is essentially a hybrid of the other two proposals and includes both the creation of private individual accounts administered by the federal government and traditional-style reforms to the current program.

The MB proposal would maintain most of the existing benefit structure of the program. However, since it used only traditional reforms, this proposal did not fully close the financing gap and restore actuarial balance. To achieve long-term actuarial balance, the MB group considered an option that involved investing about 40 percent of the Trust Funds' assets in private securities, such as through stock and bond mutual funds. This approach, in essence, would have expanded the extent to which the program was advance funded. In the end, the MB group simply recommended that this Trust Funds investment option be studied further.

The other two Advisory Council proposals include systems of individual accounts. The PSA proposal would divert a portion of the existing payroll tax into accounts that would be managed privately, while the remainder of the payroll tax would go to finance a public benefit that would be smaller than current benefits are for most beneficiaries. Under this plan, 5 percentage points of the employee's share of the current OASDI tax rate

[17]Vol. 1, app. II, of the Advisory Council's report contains an evaluation of the three proposals. Report of the 1994-1996 Advisory Council on Social Security, Volumes I and II (Washington, D.C.: Advisory Council on Social Security, 1997) can be accessed at the following Internet site: http://www.ssa.gov/policy/adcouncil/toc.htm.

[18]We define "traditional" reform proposals as those aimed at improving Social Security's solvency while maintaining the basics of the program's revenue and benefit structures and preserving the federal government's role in the program's administration. A proposal to adjust the revenue provisions of the program is an example of a traditional proposal.

would be diverted to an individual account.[19] The accounts would be individually owned and privately managed, and individuals would choose from a variety of investments in private financial instruments. The accounts would be tax-deferred, and individuals could begin drawing from them at age 62. Any funds remaining in an account upon the death of the owner would become a part of the estate. The individual accounts would represent a second tier of benefits, with a modified version of the existing Social Security program benefits maintained as the smaller first tier.[20]

The IA option would essentially maintain the structure of the existing system, with adjustment, as a large first tier and add an individual account component as a supplemental second tier. Under this proposal, workers would be required to contribute an additional 1.6 percentage points of taxable payroll to fund the individual accounts. The accounts would be invested in private securities, and workers could choose among such investments as stock and bond mutual funds and government securities. However, these accounts would be administered largely through the existing Social Security program. The account accumulation would also be required to be annuitized through Social Security, a feature not included under the PSA plan.

While these three Advisory Council options tend to dominate the current debate, numerous other proposals and options have also been advanced by various organizations, academics, and members of the Congress.[21] For example, in the 104th Congress, proposals were advanced by Senators Kerrey and Simpson (S. 824, S. 825, and S. 2176) and Representative Nick Smith (H.R. 3758) and, in the 105th Congress, by Senator Judd Gregg (S. 321), Senator Daniel Patrick Moynihan (S. 1792), Representative Mark Sanford (H.R. 2768 and H.R. 2782), Representative John Porter (H.R. 2929), and Representative Nick Smith (H.R. 3082). Numerous other proposals have been offered recently by organizations such as the National Taxpayers' Union Foundation and the Committee on Economic

[19]The current OASDI tax rate is 12.4 percent of taxable payroll, or 6.2 percent for employer and employee each. Thus, 5 percentage points represents about 80 percent of the employee portion and about 40 percent of the combined payroll tax.

[20]This first tier would also encompass modified ancillary benefits. A number of adjustments would be made to both benefits and the retirement age so that this first tier would continue to be self-financing. Full eligibility would result in an indexed basic benefit equivalent to $410 per month in 1996, and the benefits arising from individual account accumulations would supplement this level. This new first tier of Social Security benefits would be equivalent to about 65 percent of the current poverty level.

[21]For a detailed summary of several major proposals, including the Advisory Council proposals, see Employee Benefit Research Institute (EBRI), Assessing Social Security Reform Alternatives, App. A, Dallas L. Salisbury, ed. (Washington, D.C.: EBRI, 1997); EBRI Notes, Vol. 19, No. 4, (Apr. 1998), pp. 6-10; and the National Academy of Social Insurance, Social Insurance Update, Vol. 1, No. 3 (Dec. 1996).

Development, as well as by various economists and analysts (see bibliography).

Although the Board of Trustees has indicated the program is expected to have sufficient assets and revenues (including interest on the Trust Funds) to pay all benefit obligations for the next 3 decades with no changes to the program, most analysts believe early action to reduce the actuarial imbalance is important for a number of reasons. First, the longer action to address the program's financing problem is delayed, the larger the per-year cost of the solution because the shortfall in revenues will still have to be addressed, but over a shorter period of time. Second, some of the possible solutions to the solvency problem—such as raising the program's NRA, reducing benefits for future beneficiaries, or increasing the program's advance funding—will take time to implement or phase in, once enacted. Third, if certain changes, especially those that reduce benefits, are made, workers will need time to adjust their saving and retirement goals to help mitigate the personal impacts of these changes. Thus, the sooner the changes are made, the less disruptive they are likely to be.

Objectives, Scope, and Methodology

The Chairman and Ranking Minority Member of the Senate Finance Committee asked us to discuss (1) the various perspectives that underlie the current solvency debate, (2) the reform options within the current structure, and (3) the issues that might arise if Social Security were restructured to include individual accounts. We also discuss the likely effects on national saving of reform proposals that call for more advance funding of Social Security benefits.

Because of the wide-ranging nature of the numerous proposals being advanced, our report focuses on the common, or generic, elements that underlie various proposals to reform Social Security financing rather than a complete evaluation of specific proposals. In conducting this study, we reviewed literature on Social Security's long-term financing problem and related issues as well as a number of proposals that would address this problem. We held discussions with SSA officials and with other subject matter experts from government, the policy community, and academia about these issues. We also drew on our own previous work. We obtained comments on a draft of this report from SSA and subject matter experts and made revisions as appropriate. We conducted our work between October 1996 and February 1998, in accordance with generally accepted government auditing standards.

Different Conceptual Rationales Underlie Social Security Reform Proposals

The need to ensure Social Security's long-term solvency has sparked a debate that has roots in the program's creation. Both at the program's inception and today, the discussion has centered around different frameworks for providing social insurance. The many and varied proposals for addressing Social Security's future solvency problem—including those put forth by the 1994-96 Advisory Council—reflect these fundamentally different perspectives on the appropriate structure for Social Security. As a result, these proposals range from traditional reforms of the current program to significant restructuring. Increased advance funding forms a core element of many solvency proposals.

The History of the Program

The Social Security program emerged in the 1930s as the nation sought to address hardships created by difficult economic conditions. Some historians of Social Security point out that prior to the Great Depression there was considerable resistance to involving the federal government in providing economic security and creating a federal social insurance program. Despite this view, there was also a developing realization that individual and voluntary actions were not adequate to address poverty among the elderly, and a number of state programs to assist the elderly were instituted. With the coming of the Great Depression and as various social movements gained attention,[22] President Franklin D. Roosevelt appointed the Committee on Economic Security to devise what came to be the Social Security program. Throughout the legislative deliberations leading to passage of the Social Security Act in 1935, the theme of attaining a consensus on the balance between government and individual responsibility was prevalent.

Over the years, the debate about the role of government has largely centered around three models: the social insurance model, the tax-transfer model, and the annuity-welfare model.[23] Given the structure of the program as it emerged in the 1930s, the social insurance model (and, to a lesser degree, the tax-transfer model) has provided the most frequently

[22]One of these was the Townsend Movement, which focused on funneling income to the elderly and encouraging consumption to spur economic expansion. See David V. Bryce and Robert B. Friedland, "Economic Security: An Overview of Social Security," in Assessing Social Security Reform Alternatives, Dallas L. Salisbury, ed. (Washington, D.C.: EBRI, 1997), p. 32.

[23]Lawrence H. Thompson, "The Social Security Reform Debate," Journal of Economic Literature, Vol. 21 (Dec. 1983), pp. 1425-67.

used framework for analyzing the program.[24] Some analysts, however, view the annuity-welfare model as a more appropriate approach for reform.

The Social Insurance Model

Workers face a variety of risks arising from the loss of earnings that can result from retirement, disability, or death. Consistent with the social insurance model, Social Security represents a way for workers to pool these risks; it offers a package of benefits that can be obtained for a given price in the form of taxes. Since the risk primarily involves the loss of earnings the taxes to finance such a program are earnings-related, as are the benefits received. In general, because such a package of benefits may not easily be obtained in private markets, the government is involved in providing the benefits. In addition to this market failure rationale for involving the government in administering such a pooling of risks, related rationales include reducing uncertainty about individuals' future retirement income; alleviating insurance market failures, such as adverse selection; addressing social concerns about income redistribution; reducing the social burden imposed by nonsavers and the short-sighted; and institutionalizing the compact between generations (filialism).[25]

In constructing the program along the lines of the social insurance model, two important—and apparently conflicting—objectives were addressed: individual equity and social adequacy. Linking benefits directly to the tax price paid, or to contributions, invokes the standard of a market return, or an "actuarially fair return," and demonstrates the individual equity principle. But pooling risks against earnings loss also involves the concept of need or a desired minimum level of benefits. Thus, the program is designed to also embody the principle of social adequacy, which involves redistribution among participants within the program. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security program.

[24]The main difference between the social insurance and tax-transfer models is that the social insurance model focuses on life cycle or intergenerational transfers, while the tax-transfer model focuses on Social Security simply as a current period tax-transfer program (Thompson, "The Social Security Reform Debate," 1983, pp. 1436-38). The tax-transfer model is probably most useful for conducting certain types of economic analyses and for analyzing Social Security in a federal budget context, but it does not provide as much insight into the underlying philosophy for social insurance as the social insurance framework does.

[25]Lawrence H. Thompson and Melinda M. Upp, "The Social Insurance Approach and Social Security," in Social Security in the 21st Century, Eric Kingson and James H. Schulz, eds. (New York: Oxford University Press, 1997), pp. 3-21.

The Annuity-Welfare Model

Some analysts advocate an alternative approach for restructuring Social Security: the annuity-welfare framework. The emergence of this model is linked with the debate that took place in the 1930s and with various economic critiques that have emerged since the 1960s.[26] The fundamental basis of this model is the view that the different components of Social Security—individual equity and social adequacy—should be addressed separately; that is, the part of Social Security that pays benefits related to contributions by workers should be separated from the part of Social Security that relates to adequacy, or maintaining a minimum level of income to alleviate poverty. This view generally leads to a rather different approach to providing retirement income.

Several key points about the annuity-welfare model and its relation to Social Security are worthy of note. First, while the individual is required to participate in Social Security, the annuity-welfare model emphasizes maximizing voluntary arrangements whenever possible. Nevertheless, the annuity-welfare model generally recognizes that because some individuals may choose to "free ride" on society by not saving adequately, and others may experience conditions during their lifetime that leave them without adequate resources, a role for government involvement may be justified. Second, Social Security is not advance funded in the manner of private pensions and does not grant contractual rights to individuals as does, for example, a pension trust arrangement. Rather, the pay-as-you-go financing structure means that current workers pay for the benefits of current retirees and that benefits are promised largely on the basis of the ability of the government to pay them in the future. Third, the connection under Social Security between benefits and contributions is loose, mainly because of the redistributive nature of the system. As a result, some individuals will receive less than a market return for their contributions, which has raised concerns among proponents of the annuity-welfare model about the value provided by the program.

There is an important fourth issue. Some see the existing Social Security structure as leading to further difficulties because decisions about the program and its impact on individuals are made through the political process. This is known as "political risk." According to this view, the design of Social Security creates the potential for program expansion

[26]In the 1960s, a critique of Social Security emerged that is closely associated with the ideas and writings of Milton Friedman and James Buchanan. Each criticized the system and advocated changing to a system that was voluntary, fully funded, and market-based. Subsequent work by others, such as Edgar Browning, refined the critique and emphasized the tendency of the political process to expand the program. The critique was extended further by Peter Ferrara, who emphasized the need for a voluntary and private system, and proposed that the individual retirement account (IRA) concept be applied to the government-managed provision of retirement income (Social Security).

because there will always be political incentives to promise higher benefits, which will be paid for disproportionately by certain groups, such as high earners or future generations.[27] In addition, higher benefits that may need to be paid for by future workers can be promised in the near term, even though the ability of the government to raise funds in the future to make good on these promises may be dependent on the political situation at the time.

Proponents of the annuity-welfare model view obtaining adequate retirement income as a matter of individual responsibility and believe that this private decision should be separate from the social decision about providing an adequate or minimum level of retirement income for those who otherwise would fall into poverty in old age. Thus, under this model, the individual may have greater control, through the political process, of the level of minimum or basic income to be provided by society because he or she is not required to participate in a larger program of social insurance that is subject to legislative and political actions.

The emergence of privatization and individual account plans as an element of the current Social Security financing debate can in large part be tied to the annuity-welfare model. Two key features of this framework are its emphasis on advance funding and on a more direct linkage between the contributions made to the system and the benefits received from it. While proponents of both the social insurance and annuity-welfare approaches agree that those who contribute more to the system should receive more from it, the existence of income redistribution in the current Social Security program weakens this linkage. Individual account proposals could strengthen the program's equity goal by establishing a system in which the returns on investments would accrue to individuals themselves.[28,29]

The Role for Government in the Two Models Differs by Degree

In general, the frameworks discussed here reflect differences in philosophies about the appropriate balance between individual and government responsibility. While both frameworks include a role for

[27]While these groups will usually be higher-income groups, this is not exclusively the case given the structure of auxiliary benefits.

[28]However, depending upon the design of the individual's account, its interaction with any remaining government-sponsored benefit, family composition, and market returns, the equity goal could be enhanced or diminished. See app. II.

[29]Individual accounts generally require a defined contribution-type benefit structure wherein contributions and earnings on these contributions determine the amount of money available to fund benefits.

government in providing retirement income and some mandatory contribution toward it, the degree of support to be provided through government is a major source of contention.

Concerning the issue of linking benefits to contributions, supporters of the current Social Security program structure argue that redistribution is a desirable goal and a major reason for a social insurance program. They object to the separation of the individual equity and social adequacy elements, as this holds the potential, in their view, for undermining the consensus for redistribution and support of the less fortunate elderly. Further, they assert, the commitment of government under a social insurance system precludes the need for contractual arrangements and, because risks are borne collectively, reduces many of the risks that would otherwise be faced individually. Supporters of the current system also argue that a primarily pay-as-you-go system is an appropriate way to finance transfers intergenerationally. Thus, these advocates propose solutions to the financing problem that essentially maintain this structure and preserve government's primary role.

Others offer proposals that would fundamentally restructure the Social Security program to reduce the role of government and increase individuals' returns. They particularly focus on increasing individual choice and responsibility and emphasize private market returns on contributions, such as could occur with individual account proposals. Consistent with this focus, they emphasize that it is important that government address the unfunded liabilities of Social Security, and they recommend moving toward a greater reliance on advance funding and away from the primarily pay-as-you-go approach now in use.

Advance Funding Is a Central Element of the Current Debate

Advance funding involves saving real assets to finance benefits promised today but paid in the future. Applying such a financing approach to the Social Security system, which is currently financed primarily on a pay-as-you-go basis, would require a period during which contributors paid twice—once for current beneficiaries and again to "advance fund" some part of their own retirement benefits. Despite this potential drawback, most proposals to reform Social Security's financing build in some degree of advance funding, arguing that the long-term economic benefits could offset short-term costs.

Advance Funding Offers an Alternate Means to Finance Future Promises

The ability to finance future benefit promises, regardless of the financing method chosen, depends fundamentally on the capacity to generate a given amount of resources that will be sufficient to meet future obligations. This can be done through a social insurance program wherein the government makes a political commitment—which may or may not include issuing debt—or, alternatively, through advance funding.

As an element of most private pension plans, advance funding involves a contractual obligation under which real assets sufficient to meet the future payments are placed in a legal trust arrangement. In contrast, pay-as-you-go requires a political commitment to levy taxes in the future.[30] Proposals for advance funding Social Security usually involve investing some portion of current Social Security contributions in private sector securities (stocks and corporate bonds) owned by the individual contributors. It would also be possible for the government to hold government securities or private securities, and this approach has been proposed as well. In both approaches, increasing Social Security's advance funding has the potential to capture returns from investment of assets; these returns could help mitigate the benefit reductions or tax increases that would otherwise be necessary to restore solvency to the system.

Supporters of advance funding point out that it offers a way to increase national saving, investment, and economic growth. They also assert that increased economic growth could raise both wages and the national standard of living, which would reduce the burden of setting aside a given level of income for retirement. Thus, they advocate reducing current consumption in order to increase future consumption.

Others suggest that the claims of those favoring advance funding may not be realized. The linkage between national saving and economic growth is not certain. Because future market returns, inflation, and life expectancies are uncertain, there is no guarantee that a given level of contributions paid into an advance funded plan would necessarily be sufficient to provide an expected, or even an adequate, benefit that would last throughout an individual's retirement. Also, an increase in personal or government saving from advance funding Social Security would not necessarily translate into an increase in national saving—for example, if the government used some current Social Security revenue to fund additional personal saving and then borrowed to continue paying current benefits.

[30]The noncontractual basis of Social Security benefits was established by the Supreme Court decision in the Nestor case (Fleming v. Nestor, 363 U.S. 603, 1960).

The Need for a Transition Period Complicates Advance Funding

To achieve full advance funding, a transition period might have to occur during which workers would have to fund both their own future Social Security benefits and the benefits for those who had already earned unfunded credits under the current program. Funding the program's currently unfunded promises through taxation could place a large burden on the first group of workers who financed their own benefits. Debt financing could reduce the burden on this group and place some of the burden on later generations that paid off the debt. The transition costs could be substantially reduced if some of the unfunded future benefit obligations were eliminated by reducing the benefits of current and future beneficiaries.

Once the transition period had passed and advance funding was fully implemented, future workers would no longer need to finance the Social Security benefits of those who were currently working. Theoretically, enough money would have been set aside by workers and employers (in either individual accounts or a collective account) to secure the benefits of each worker throughout retirement—and, depending on the proposal's design, perhaps those of his or her dependents and survivors as well. In addition, as the burden of supporting older generations decreased and investment returns funded an increasing portion of the growth in individual accounts, reducing individual account contribution rates to a level below today's OASDI payroll tax rate would be possible.

Some Advance Funding Is Present in Most Reform Proposals

The Advisory Council has proposed three packages of options. These packages capture most of the essential features that are found in other reform proposals. While the packages include adjustments of the current structure (traditional reforms), such as increasing the retirement age, changing the benefit formula, and lowering the postretirement COLA, each also contains nontraditional reforms involving increased advance funding.

Although all three of the Advisory Council proposals would increase the system's advance funding, only the PSA and the IA options call for individual account plans. The MB proposal instead would increase the system's advance funding within the current structure, and the government would invest at least some portion of the additional assets in the stock market. Thus, the Advisory Council has indicated that, to restore solvency, the element of advance funding in private investment markets should be increased, whether the Social Security program is strengthened within its current structure or fundamentally altered.

The Advisory Council's two individual account proposals represent what is generally referred to as the "privatization element" in the current debate. Precisely defining privatization in relation to the Social Security debate is difficult, but privatization is usually associated with two key elements: advance funding of retirement income through investment in private financial assets and greater individual control of decisions about investing those assets. The PSA and IA proposals would change the current benefit structure of Social Security. Individuals would receive part of their future benefit from a modified Social Security program and part from the accumulations from the individual account. These individual accounts would be, essentially, advance funded retirement income arrangements, as are private pensions, and would be similar to defined contribution pension plans, or 401(k) plans. These accounts would earn a return that depended solely on the investment performance of the assets held, and historical data suggest that the gross returns to these funded arrangements could be higher than the amounts beneficiaries could expect to receive under the current system. The opportunity for higher returns, however, would come with increased investment risk that would be borne by the individual owning the account.

A Variety of Options Could Restore Program Solvency Within the Existing Program Structure

Resolving Social Security's long-term financing problem within the program's current structure would require increasing the program's revenues, decreasing its expenditures, or both. By combining various options, it would be possible to restore Social Security's actuarial balance for the next 75 years without changing the program's benefit or financing structure. A summary table on the estimated effects of various options appears as appendix I.

The options for increasing revenues include expanding coverage to additional workers, raising the payroll tax rate, expanding taxable payroll through increasing the maximum taxable earnings level or including nonwage compensation as covered earnings, increasing the income taxation of Social Security benefits, using general revenues, and changing investment policy to earn a higher rate of return on the Trust Funds' assets.

The options for reducing expenditures include eliminating or reducing some existing benefits; reducing initial benefits through changing the current benefit formula or increasing the NRA, the early retirement age (ERA), or both; and controlling the growth of benefits after entitlement through improving COLA calculations, limiting COLA increases, limiting the recomputation of benefits, restrengthening the earnings test, disallowing most "new dependent" benefits,[31] or reducing benefits because of other income. A number of these options have been used in the past to ensure the solvency of Social Security.

Increasing the element of advance funding within the current program structure is also a means of addressing the solvency problem. Increasing the Social Security Trust Funds' assets would require determining how the government might best reserve those funds for future benefits.

Options for Increasing Program Revenues

Revenues can be increased by expanding coverage, raising additional revenues through the existing payroll tax structure, and raising revenue from other sources.

Expanding Coverage

One way to increase revenues is to expand the number of jobs covered by Social Security. This option was first used in 1950. The original Social

[31]"New dependents" are those who become entitled to dependent benefits because of either (1) a marriage that occurs after the primary beneficiary becomes entitled to benefits or (2) the birth of a dependent beneficiary that occurs more than a specified period of time (for example, 9 months) after the primary beneficiary becomes entitled.

Security Act covered about 60 percent of the U.S. workforce. Today, about 96 percent of the workforce is covered. This option increases revenues relatively quickly and improves solvency for some time, since most of the benefits for the newly covered workers are future obligations.

Most beneficiaries have received more in lifetime benefits than they have paid in payroll taxes. This would suggest that increasing coverage would have a long-term negative impact on the program's solvency. However, the Advisory Council estimated that covering most of the remaining noncovered jobs would actually have a positive effect on program solvency because many of the newly covered workers would already be eligible for Social Security benefits because of earnings in other covered employment.

A majority of the members of the 1994-96 Advisory Council recommended that all newly hired state and local government workers, who would not otherwise be covered by Social Security, be covered.[32] They estimated that this change would represent a net improvement in actuarial balance equivalent to 0.22 percent of taxable payroll over the next 75 years, or about 10 percent of the currently estimated long-term revenue shortfall.

Raising the Payroll Tax Rate

Revenues could also be raised by increasing the OASDI payroll tax rate paid by workers and their employers (currently 6.2 percent of covered earnings for each) and by the self-employed (currently 12.4 percent).[33] Until 1978, this action was taken quite regularly, usually by announcing scheduled increases some years in advance to give workers and employers time to adjust. The 1977 amendments to the Social Security Act were the last to raise the OASDI rate for workers and employers (to 6.2 percent, effective in 1990). The 1983 amendments raised the payroll tax rate for the self-employed to 12.4 percent, effective in 1990. No future increases are scheduled even though the retirement of the baby boom generation is imminent. Raising the payroll tax rate by about 1.1 percentage points for

[32]Implementing this recommendation would effectively eliminate the expansion of coverage as a source of additional program revenues because almost all jobs would be, or soon would be, covered by Social Security. It would also increase employment costs for some states and localities because they would have to pay the employer's share of the payroll tax. This increase in costs would require states and localities to reduce their expenditures or increase their revenues. To offset some of these cost increases, these government entities might consider modifying the pension systems for newly hired workers. The disposable incomes of many newly hired workers would likely be reduced relative to those of current workers because these new hires would have to pay both the employee's share of the payroll tax and any required or voluntary pension contributions to their modified pension plans.

[33]The OASDI tax rate was initially set at 1 percent of the first $3,000 of earnings for both the employee and the employer. The rate increased 20 times between 1937, when the tax was first collected, and 1990, when the rate reached its current level.

both employees and employers could eliminate the program's currently projected long-term revenue shortfall.

One advantage raising the payroll tax has over several other revenue-enhancing options, from both programmatic and federal budget perspectives, is that it would not result in higher future benefits because benefits are based on covered earnings, not total contributions. Raising revenues by expanding coverage or expanding the definition of taxable earnings, on the other hand, would result in future benefit increases for the affected workers, thereby reducing the net long-term gains to the program and to the federal budget.

Disadvantages of raising the payroll tax include lower disposable income for workers and higher labor costs for employers. Moreover, a higher payroll tax would also lower the value of the program to workers because future benefits for them and their dependents and survivors would not increase. Because employers' additional costs would be tax-deductible, their business income taxes would fall, but by less than the payroll tax increase. The end result would be that employers' net incomes would fall somewhat, and federal income tax revenues would decline.

In addition, the Congress might be reluctant to further increase the payroll tax rate because (1) it and other tax rates are already considered too high by many, (2) many workers already face higher payroll taxes than income taxes, and (3) the payroll tax is regressive. The Advisory Council concluded that there is little political support for bringing the program back into financial balance through payroll tax rate increases alone. However, all three Advisory Council proposals contained payroll tax increases as a part of their recommended solution to the program's solvency problem. One recommended an immediate and permanent payroll tax increase, one a permanent increase beginning in about 50 years, and one a temporary (70-year) increase. Moreover, the Medicare program faces a more immediate solvency problem than does Social Security, and increasing the payroll tax rate to improve the long-term financial solvency of one program limits the extent to which this option can be used to improve the long-term financial solvency of another.

Expanding Taxable Payroll

There are two ways to expand the taxable payroll base: raising the maximum level of earnings subject to the payroll tax and including some nonwage compensation in the definition of taxable payroll.

Increasing the Maximum Taxable Earnings Level

Over the years, the maximum taxable earnings level has risen from $3,000, initially, to $68,400 in 1998. In 1995, covered earnings accounted for about 88 percent of all earnings for employees and about 72 percent of reported self-employment net earnings. Overall, about 87 percent of all earnings were covered by Social Security. The maximum taxable level is automatically adjusted to the growth in national wages, and this generally increases program revenues over time.

While increasing the taxable earnings level would generate additional program revenues immediately, it would also increase future costs by raising benefits for those high earners who would pay the additional payroll taxes. However, because the additional covered earnings generally would increase the benefits of high earners only modestly (recall that the rate of earnings replacement for the highest increments of the AIME is only 15 percent), raising the maximum taxable earnings level could increase revenues in both the short and long run. Social Security actuaries estimated that raising the maximum taxable earnings level in 1997 and later so that 90 percent of all earnings were taxable (a 3-percentage point increase over current levels) would improve the program's long-range actuarial balance by 0.48 percent of taxable payroll, or the equivalent of about 22 percent of the program's estimated 75-year financing shortfall.

Including Some Nonwage Compensation as Covered Earnings

Over the past few decades, the proportion of total compensation paid in the form of wages and salaries has declined, and nonwage compensation (payments for pension contributions and health insurance, for example), which is not subject to the payroll tax, has risen to about one-third of payroll. This increase in the benefits portion of total compensation has reduced the relative amount of total compensation subject to the payroll tax. Social Security revenues could be increased if some or all of these nonwage compensation costs were included in the definition of taxable payroll.[34] Estimates made for the Advisory Council suggest that including employer-provided group health and life insurance or pension and profit-sharing contributions in OASDI taxable earnings would improve the program's long-term actuarial balance by 0.80 and 0.37 percent of taxable payroll, respectively. Combined, these two options represent about one-half of the anticipated financing shortfall.

This option could present some difficulties in implementation, however. Employee benefits generally are greater for highly paid workers whose

[34]However, subjecting these nonwage forms of compensation to payroll taxation could reduce their attractiveness to both employers and employees. If this occurred, there could be a reduction in the provision of these forms of compensation, leading to a decrease in total retirement income for some workers in the future.

wage compensation may already exceed the maximum taxable earnings limit. Thus, subjecting their nonwage compensation to the payroll tax would not raise additional revenues. Also, it could be difficult to separate nonwage benefit costs on an individual basis.[35] If such an individual allocation could be made, the increase in taxable payroll would increase the future benefits of many workers. An alternative would be for only employers to pay the additional tax on nonwage compensation. Subjecting all employer-sponsored private pension and profit-sharing contributions to a 3-percent payroll tax and crediting these contributions as earnings to individual workers would improve OASDI's long-term actuarial balance by an estimated 0.15 percent of taxable payroll.

Increasing the Income Tax on Social Security Benefits

Up to one-half of Social Security benefits have been subject to individual income taxes since 1984.[36,37] These revenues are returned to the Social Security Trust Funds. Taxing Social Security benefits can be considered either a form of means testing benefits—because one's total Social Security benefit is effectively reduced as income rises—or a way to partially fund the program out of general revenues.

Increasing revenues by taxing Social Security benefits could be accomplished by several means, including lowering or eliminating the income thresholds at which benefits become taxable, taxing all benefits above the amount of the employee's contributions, redistributing to Social Security the portion of benefit taxation currently going to Medicare, and treating all Social Security benefits as normal taxable income subject to the current income tax rules. Eliminating the thresholds but otherwise keeping the benefit taxation provisions as they are is estimated to improve the program's long-term actuarial balance by 0.21 percent of taxable payroll. Lowering or eliminating the thresholds would require increased income tax payments from some lower-income beneficiaries;

[35]Employers often make their payments for these benefits in lump sums (for example, they might pay $1 million as a premium to provide their workers with health care coverage) and do not generally determine how much of this payment should be allocated to each employee. Indeed, determining an appropriate allocation for each employee would prove to be a daunting task in many instances.

[36]The 1993 amendments to the Social Security Act made up to 85 percent of Social Security benefits subject to income taxation. However, the additional revenues collected from this source are dedicated to the HI Trust Fund and do not increase OASDI revenues.

[37]Individual income tax filers pay the tax if their adjusted gross income plus tax-exempt interest income plus one-half their Social Security benefits exceed $25,000. A married couple filing jointly will pay the tax if this income exceeds $32,000. The threshold for married couples filing separately is $0 (half of all Social Security benefits are automatically subject to taxation) if the couple lived together at any time during the tax year. The thresholds are not indexed, so the percentage of beneficiaries subject to this tax will rise as the nominal amount of their total income, as taxable for this purpose, increases.

higher-income beneficiaries would not contribute more unless the proportion of benefits subject to this tax was also increased. Taxing all Social Security benefits that exceeded the worker's own contributions would save another 0.15 percent of taxable payroll. Shifting the HI portion of benefit taxation to OASDI would save 0.36 percent, but at the expense of worsening Medicare's solvency problem. Finally, making all Social Security benefits subject to the income tax while keeping the current thresholds in place would increase income taxes for both those higher-income beneficiaries currently paying the tax on Social Security benefits and those whose total incomes are close to, but below, the current thresholds.

Using General Revenues

The program's revenues could also be increased by partially funding the system with money from other government revenue sources.[38] General revenue funding of the program has been used in the past, most notably during the program's 1982-83 financing crisis.[39] General revenue financing of a portion of Social Security expenses could be accomplished by dedicating a portion of existing general revenues to the Social Security program; creating a new tax, such as a national consumption tax, with proceeds dedicated to Social Security; and reducing expenditures on other federal programs and using the cost savings to help fund the program.

Earning a Higher Rate of Return on the Trust Funds' Assets

Currently, the Trust Funds are invested in Treasury securities that earn a relatively low rate of return. Investing a portion of Social Security Trust Funds in the stock market could increase the return to the fund, albeit with a risk of capital loss. While stocks and other investments do not outperform Treasury securities every year, they have, over the long term, performed much better.

Higher investment earnings could extend the life of the Trust Funds without other program changes. As we reported previously, investing the projected Trust Funds' surpluses, absent other changes to the Social Security program, could extend the life of the Trust Funds by almost 11

[38]Some of the original designers of the program assumed that the government would eventually share in the costs of the program.

[39]The 1983 amendments directed the Treasury to make payments to the OASDI Trust Funds from general revenues for unfunded gratuitous military service credits for military service after 1939, the value of uncashed benefit checks issued in the past (including interest), revenues from the income taxation of up to 50 percent of Social Security benefits paid, and tax credits given for Federal Insurance Contributors Act and Self-Employment Contributions Act taxes paid by workers from 1984 through 1989.

years, assuming stock returns remained at the historical average.[40] If this were implemented in isolation, the Trust Funds would inevitably have to liquidate the stock portfolio to pay promised benefits and would be vulnerable to losses in the event of a general stock market downturn. While stock investments alone would not completely address the program's long-term solvency, they could lessen the size of other program changes needed to bring the program to solvency. This option is addressed in greater detail in the advance funding discussion later in this chapter.

Options for Reducing Program Expenditures

Until the 1970s, most attempts to address financing problems focused on increasing program revenues. But expenditures can be controlled, or reduced, in numerous ways, including eliminating or reducing some existing benefits, reducing initial benefit levels, and slowing the increase in benefits once they have been initiated.

Eliminating or Reducing Some Existing Benefits

Eliminating benefits has been used only sparingly in the past, most notably in the early 1980s when the following benefits were abolished: the minimum Social Security benefit for those attaining age 62 after 1982, child benefits for students aged 18 to 22, and benefits for (widowed) mothers and fathers whose youngest nondisabled child has attained age 16.

Reducing benefits for selected beneficiaries has been used a little more often. In 1967, a limitation of $105 per month was placed on spousal benefits, but this limit was quickly removed in 1969. The process for determining Social Security benefits was modified in 1977 to offset unintended increases in initial benefit levels that resulted from a benefit calculation process first used in 1975. In 1980, the method of computing the applicable family maximum benefits on the basis of the earnings records of those who became disabled after June 1980 was changed in a way that effectively limited the total benefits the spouses and children of disabled workers could receive. Social Security benefits were also reduced in 1977 and 1983 for those who had pensions from noncovered

[40]See Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy (GAO/AIMD/HEHS-98-74, Apr. 22, 1998).

government employment at the federal, state, or local level.[41] In addition, the 1983 program amendments reduced benefits by delaying the COLA for 6 months and by raising the NRA for those born in 1938 or later.

Spousal, Survivor, and Dependent Child Benefits

The spouses, children, and parents of retired and disabled workers, as well as survivor beneficiaries, receive Social Security benefits that are based at least in part on the covered earnings record of retired, disabled, or deceased workers. These benefits were added in 1939 to ensure that a worker's family had adequate benefits once the worker retired; died; or, after 1956, became disabled. These benefits currently account for more than 25 percent of all program expenditures. No absolute measure of need or adequacy has ever been applied to these benefits. For example, eligible spouses receive a benefit based on one-half the worker's PIA regardless of the amount of the worker's benefit. At the end of 1996, 73 percent of the spouses of retired workers had their benefits based on PIAs of $800 or more, fewer than half of all retired workers had their benefits based on PIAs this high, and less than 40 percent of disabled beneficiaries but more than 50 percent of their spouses had benefits based on PIAs of $800 or more.[42] The average PIAs on which children's benefits were based also exceeded those of retired or disabled workers.

Limiting spousal benefits could be accomplished by, for example, capping them at one-half the average retired worker's PIA, or by phasing them out if the combined benefits of the worker and spouse exceeded a given threshold. The benefits of workers with low lifetime earnings and those of their spouses would continue to be paid as under current law, but the benefits for spouses of workers with higher than average PIAs would be reduced. Limiting spousal benefits to one-half the average PIA of retired workers as of December of the prior year is estimated to improve the program's long-term actuarial balance by 0.21 percent of covered payroll.

At the end of 1996, benefits for most types of survivors were also based on average PIAs that were higher than the average PIAs of retired workers, although not as high as PIAs for spouses. The maximum monthly benefit

[41]These reductions are the result of the windfall elimination provision (WEP), which is intended to reduce the retired worker benefits of the affected workers, and the government pension offset (GPO), which is intended to reduce or eliminate the Social Security spouse or survivor benefits the worker might have been entitled to on the basis of his or her spouse's earnings record. The WEP and GPO were enacted to keep workers with substantial work in noncovered employment from taking advantage of the progressiveness of the Social Security benefit formula, which is intended to boost the Social Security benefits of long-term, low-wage workers and workers who have only marginal attachment to the labor force.

[42]At this time, the average PIA for a retired worker was $753 and for his or her spouse, $939. The average PIAs for disabled workers and their spouses were $711 and $834, respectively.

for a worker retiring at age 65 in 1996 was $1,284 in December of that year. More than 1 million beneficiaries receiving only survivor benefits at that time had their benefits based on PIAs of $1,100 or more, and 38 percent of these had benefits in excess of $1,250 that month.[43] At the same time, about 200,000 beneficiaries were entitled to combined retired worker and survivor benefits in excess of $1,200 (averaging about $1,400). Thus, hundreds of thousands of survivor beneficiaries received benefits in excess of what a 65-year-old worker retiring in that year could have received. If it were desirable to do so, this situation might be addressed by, for example, capping survivor benefits at some percentage above the poverty threshold, at the average retired worker benefit level, or at the maximum benefit available to a worker attaining age 65 in the year the survivor became widowed.[44]

Costs could also be reduced by modifying children's benefits. For example, eliminating benefits for nondisabled children of retired workers is estimated to save 0.05 percent of taxable payroll. Also, the level of benefits for children of disabled and deceased workers could be made dependent on the earnings that continue to come into the household from the nondisabled or nondeceased parent and not just on the child's own earnings. There is already a precedent for this type of reduction, in that the benefits of auxiliary beneficiaries can be reduced not only by their own earnings but also by those of the retired worker. This action would save about 0.04 percent of taxable payroll over the 75-year period.

Capping or eliminating certain spousal, survivor, and dependent child benefits, or tying them to the amount of household income, could ensure that lower-earning families continue to receive adequate auxiliary benefits while higher-earning families do not receive benefits that are difficult to justify on adequacy grounds.

Disabled Worker Benefits

The disability insurance (DI) program has been one of the fastest growing Social Security-administered programs over the past 10 years. Controlling the growth in the DI program would be an important way to control overall program expenditure growth. This could be done by tightening program eligibility requirements; making determinations of eligibility at various review levels more consistent; taking action to encourage DI beneficiaries

[43]This occurred primarily because the recomputation of benefits for those with covered earnings after age 65 increased their PIAs and their survivors' benefits above the maximum $1,284 a 65-year-old worker could receive in December 1996.

[44]This last action would save only about 0.01 percent of covered payroll over the 75-year evaluation period.

to return to work; limiting how long DI beneficiaries can be on the rolls;[45] reducing DI benefits by lowering initial levels of all benefits; and limiting the initial disabled worker benefit to the retired-worker benefit available at age 65, using the current law's increasing retirement ages and adjustment factors. This last means of reducing disabled-worker benefits is estimated to improve the program's long-term solvency by 0.40 percent of taxable payroll.

Reducing Initial Benefits

Expenditures for retired-worker benefits will increase rapidly once the baby boom generation begins to retire. To help control these anticipated expenditure increases, initial benefits for all beneficiaries could be reduced through (1) changing the current benefit formula and (2) increasing the NRA or the ERA—or both. Reducing the growth in benefits once they are received is also an option.

Changing the Current Benefit Formula

Benefits for those born in 1929 or later are based on the average of a worker's 35 years of highest indexed covered earnings. Earnings received before age 60 are wage-indexed to the year the worker turned age 60.[46] Once the average indexed monthly earnings are determined, a formula converts them to the PIA. Benefits equal 90 percent of average earnings up to a threshold ($477 for 1998), plus 32 percent of average earnings above this first threshold until a second ($2,875) is reached, plus 15 percent of average earnings the worker might have above this second threshold. The PIA is then adjusted for the age the worker first receives benefits. The benefit is lowered if benefits are first taken before the NRA (currently age 65) and increased if benefits are first received after the month the worker attains the NRA but before age 70.

Initial benefits could be reduced by changing the values of components of the benefit formula—for example, increasing the number of years of earnings included in the computation period from 35 to 38, as a majority on the Advisory Council advocated. The indexed earnings of the additional 3 years would, by definition, be no larger than the indexed earnings of the year of lowest earnings included under current rules. This change would result in a decrease in both average indexed earnings and benefit amounts for all new beneficiaries.

[45]See Social Security Disability: SSA Must Hold Itself Accountable for Continued Improvements in Decision-making (GAO/HEHS-97-102, Aug. 12, 1997); Social Security: Disability Programs Lag in Promoting Return to Work (GAO/HEHS-97-46, Mar. 17, 1997); and Social Security Disability: Improvements Needed to Continuing Disability Review Process (GAO/HEHS-97-1, Oct. 16, 1996).

[46]Earnings at age 60 and older are not indexed.

The reductions from extending the computation period would be larger for those with limited or intermittent attachment to the labor force than for those with continuous attachment, because more years of $0 earnings would be included in the computation formula—for example, women would be more affected than men. According to the Advisory Council's report, increasing the computation period would reduce benefits by 3 percent, on average, and improve the program's long-term actuarial balance by 0.28 percent of taxable earnings. Those with 35 or fewer years of earnings, however, would experience about an 8-percent decrease in AIME, and many beneficiaries with fewer than 36 years of earnings already have relatively low AIMEs. This change would reduce the benefits for those with low lifetime covered earnings more than for those with high lifetime covered earnings. A $1 decrease in AIME could reduce the PIA of a low earner by 90 cents, while the PIA of the highest earners would be reduced by only 15 cents.

Another way to reduce initial benefits would be to lower either the rates of earnings replacement or the bend points that convert average earnings to benefits. Reducing all replacement rates would reduce benefits for everyone, including those with the lowest AIMEs and benefits.[47] Gradually reducing each of the three replacement rates by 0.5 percent between 2020 and 2029 and maintaining them at the new, lower levels thereafter is estimated to improve the program's long-term actuarial balance by 0.29 percent of taxable payroll.[48] Reducing the bend points would protect the benefits of those with the lowest benefits but reduce benefits for everyone with average earnings above the new (lower) first bend point. Indexing the bend points in the benefit formula by either the current consumer price index or the annual wage index minus 1 percentage point rather than by the average wage index would be expected to reduce the new benefit rate of growth. Either index adjustment would improve the program's long-term actuarial balance by 1.54 percent of taxable payroll, about 70 percent of the long-term financial imbalance.

Initial benefits could also be reduced by increasing the reduction factor for early retirement and reducing the incremental increase for first receiving benefits after the NRA. In addition, the benefit formula could be reduced by indexing benefits to a younger age than age 60 or by using an index that

[47]Reducing only the middle and lowest replacement rates would preserve the PIAs for all those whose AIMEs are at or below the first bend point. Reducing only the lowest replacement rate would reduce PIAs for only those with the highest AIMEs.

[48]Such a reduction would lower the current replacement rates of 90 percent, 32 percent, and 15 percent to 85.5 percent, 30.4 percent, and 14.25 percent, respectively.

grows more slowly than national wages. These last changes would reduce Social Security's measure of lifetime covered earnings which, in turn, would reduce calculated benefits.

Increasing the NRA, the ERA, or Both

An increase in the NRA would be tantamount to a graduated benefit reduction for all affected beneficiaries. Some policymakers are concerned that this additional reduction in benefits for those who retire early—especially for those who have health problems and for those who are widows—would reduce the adequacy of their benefits and result in an impoverished retirement.

The NRA has already been increased once. The package of program changes used to resolve the program's 1982-83 financing crisis included a provision to gradually increase the NRA from age 65 to age 67 beginning with those born in 1938 (and attaining age 62 in the year 2000). The NRA increase will be fully phased in for those born in 1960 or later.[49] However, the ERA of 62 was not changed.

Increasing the NRA further can be justified because life expectancies at age 65 are longer now than they were in 1940, the year benefits were first paid.[50] The longevity trend is an important reason for the growth in Social Security costs. Increasing the NRA would be one way to control program costs because benefits available at all ages would be lowered, and this could provide an incentive for some workers to delay their initial receipt of retired worker benefits.

How much to increase the NRA would depend on the goal of the increase. If the goal was to keep the program solvent, the increase in the NRA could be

[49]The legislated change in the NRA of 65 increases it by 2 months each year for those born from 1938 to 1943. That is, the NRA of a person born in 1943 is now 66. The NRA will not be increased for those born from 1944 through 1954 (the hiatus)—it will remain at age 66. Those born from 1955 to 1960 will again see their NRA increase by 2 months each year. The NRA for those born in 1960 and later will be age 67. For example, those born in 1938 will have to wait until they are 65 years and 2 months old to receive their PIA or "full benefit." If they retire during the month they attain age 62 or 65, for example, they will receive only 79 or 99 percent of their PIA, whereas they would have received 80 or 100 percent if they had they been born 1 year earlier. These reductions will continue to grow for those born from 1938 to 1943 and again for those born from 1955 to 1960. Those born after 1959 will receive only 70 percent of their PIA at age 62 and about 87 percent at age 65, compared with today's 80 percent and 100 percent, respectively.

Eliminating the currently scheduled hiatus so that an NRA of age 67 would be reached for those born in 1949 and indexing the NRA thereafter to keep the proportion of the average adult lifetime that is above the NRA constant are estimated to improve OASDI's long-term actuarial balance by 0.50 percent of taxable payroll.

[50]Life expectancies at age 65 have increased by about 30 percent for men and about 40 percent for women since 1940.

calculated once the other actions to maintain solvency had been decided on. However, the goal of increasing the NRA could also be either to keep life expectancy at the NRA constant (using life expectancy at age 65 in 1940 or some other year as a base) or to maintain a life expectancy at the NRA that is a constant proportion of one's life expectancy as an adult (life span after age 20).[51] For example, in 1940 at age 65 the average life expectancy was just under 13 years. To keep the same 13-year life expectancy at the NRA in 1995, the NRA would have had to be age 72. Alternatively, in 1940 the average person aged 65 would have expected to spend about 22 percent of his or her adult life older than the NRA. In 1995, spending 22 percent of one's adult life above the NRA would require an NRA of age 70, using the Social Security Actuary's projections of life expectancies. Given either of these two goals, the NRA would need to be increased as life expectancies continue to improve.

More than 50 percent of newly retired workers elect to receive benefits at age 62. Increasing the ERA would preclude workers from claiming benefits between age 62 and the new ERA and could, therefore, increase the incentive to apply for DI benefits at those ages. Social Security would receive some short-term financial savings because these potential beneficiaries would have to delay the receipt of benefits. However, because benefits are adjusted on an actuarial basis, the initial benefits of affected workers would be larger than if the ERA had remained at age 62, and long-term program savings would be low.

Raising the NRA, the ERA, or both could place a large burden on the DI program and result in lower net savings than might be expected. Raising the NRA would increase the reduction factor applicable to those retiring at the ERA, giving them lower benefits than they currently receive. Raising the NRA would not reduce the amount of the DI benefit, however, unless DI benefits were reduced independently. The benefit gap between DI benefits and the new, lower retirement benefits for everyone below the new NRA would rise, providing an incentive for some, who would not otherwise do so, to apply for DI benefits.[52] DI caseloads and costs would grow if the number of applicants increased and, if some of these additional applicants

[51]We calculated this proportion by dividing the life expectancy at the NRA by the NRA plus the life expectancy at the NRA, minus 20.

[52]For example, under current law, retired worker benefits taken at age 62 after the NRA has increased to age 67 will be 70 percent of the worker's PIA. Disability benefits will remain at 100 percent of PIA. If a 62-year-old worker in marginal health decided to apply for disability benefits rather than reduced retired worker benefits and was approved for DI benefits, his or her monthly benefits would be about 43 percent higher, for life. This level of potential increase in monthly benefits could provide a strong incentive for many retirement-eligible people with health problems to apply for disability benefits.

were allowed on the DI rolls, DI benefit costs (and total OASDI costs) also would increase.

Controlling the Growth in Benefits After Entitlement

In addition to reducing the level of initial Social Security benefits, controlling the growth of benefits after initial receipt is another way to reduce program expenditures. Various possible actions are discussed below.

Improving COLA Calculations

Since 1975, Social Security benefits have been automatically increased to keep pace with inflation using the consumer price index as the inflation index. This automatic increase allows benefits to maintain their purchasing power over time.[53] However, COLAs are costly. Social Security currently pays about $370 billion a year in benefits. Each 1-percent increase in the COLA costs the program an additional $3.7 billion. Because COLA increases are cumulative, their impact on program expenditures grows rapidly. For example, those who first received benefits in the first half of 1975 currently receive monthly benefits that are 187 percent higher (in nominal terms) than their original monthly benefit; that is, for each $100 received in early 1975, $287 is received in 1998.

Recently, a congressional commission reported that the consumer price index overstates the true rate of inflation on average by about 1.1 percentage points yearly, and that this may result in overcompensation of beneficiaries.[54] Many economists agree that the consumer price index probably overstates the rate of inflation but differ on the degree. Even the Bureau of Labor Statistics, which calculates the increase in the index, consistently states that it is not a measure of inflation.

Improving the calculation of the COLA, either by making the consumer price index a more accurate measure of inflation (which is technically difficult to do) or by adjusting it after the fact to better measure true changes in inflation, is a desirable option. Given the direction of the current bias in the index, such an adjustment would lower yearly COLAs and result in long-term improvements in the program's solvency.

[53]For most retirees, Social Security benefits are the only source of retirement income that maintains its purchasing power through time. Other sources generally fail to keep pace with inflation or disappear at some point after retirement. Thus, most retirees become more and more dependent on Social Security benefits as they age.

[54]Michael J. Boskin and others, Toward a More Accurate Measure of the Cost of Living, final report to the Senate Finance Committee from the Advisory Commission to Study the Consumer Price Index (Washington, D.C.: Advisory Commission to Study the Consumer Price Index, Dec. 4, 1996).

Limiting COLA Increases

Reducing COLAs could control the growth in Social Security benefit expenditures. Expenditure savings would be apparent immediately, and savings in 1 year would carry forward in later years in a cumulative manner. In addition, COLA reductions would affect current as well as future beneficiaries, spreading the burden of the program's financial reform over a broader population. Not all other actions to resolve the program's long-term solvency problem would affect current beneficiaries.

COLA reductions could be achieved by several means, including

- lowering the COLA to less than the measured rate of inflation (for example, consumer price index minus 1 percentage point);[55]
- capping the COLA (increasing benefits by the consumer price index increase or, for example, 2.5 percent, whichever is less);
- delaying the COLA;
- eliminating the COLA;
- changing the index used to measure the COLA;
- not providing a COLA until cumulative inflation since the previous COLA increase exceeds a specified threshold, such as 5 percent; and
- allowing a full COLA up to some specified threshold (for example, the average PIA amount) and then reducing or eliminating COLAs for benefits above that threshold.

These alternative ways of reducing COLAs would have differing impacts on certain individuals and households. For example, changing the COLA by reducing the consumer price index by 1 percentage point forever would gradually reduce the purchasing power of benefits as beneficiaries age. A reduction in the COLA from, for example, 3.5 percent to 2.5 percent annually would reduce the purchasing power of benefits by about 9 percent after 10 years, 22 percent after 25 years, and 32 percent after 40 years. Alternatively, giving full COLAs for benefits below some threshold (the average PIA amount, for example) and giving reduced or no COLAs for benefits above that threshold would fully protect the purchasing power of benefits for those with low benefit levels while gradually reducing it for those with higher benefit levels.

Reducing COLAs would have an important drawback, however. The purchasing power of Social Security benefits would gradually shrink over time. As they age, some beneficiaries with little or no additional retirement income could be pushed into poverty as a result of COLA cuts. This could be

[55]Reducing the COLA to equal the consumer price index minus 1.0 or 0.5 percentage points beginning in 1998 is estimated to improve OASDI's long-term actuarial balance by 1.39 or 0.72 percent of taxable payroll, respectively.

a particular problem for single (widowed, divorced, or never married) elderly women who already have one of the highest poverty rates of any population subgroup in the nation. In 1994, 22 percent of single women aged 65 or older lived in poverty, and another 12 percent had incomes between 100 percent and 125 percent of the poverty line. As more beneficiaries fell into poverty, more would become eligible for government-provided safety net programs, such as Supplemental Security Income (SSI). Increases in the costs for these safety net programs would partially offset the savings to Social Security from the COLA reductions.

Limiting the Recomputation of Benefits

The benefits of those who continue to work after age 62 are recomputed to account for their new earnings, even if they receive benefits while working. If their current earnings are larger than the smallest earnings currently used in calculating their current benefit level, the new earnings will replace those smallest earnings, and their benefits and those of their dependents will increase for all future years.

Another way to reduce future program costs would be to limit the recomputation of benefits, which could be done by allowing recomputation of the benefits of only those who did not receive any benefits during the year they worked; capping benefits at the maximum benefit payable to someone in that worker's birth cohort who first drew benefits at age 65, adjusted for subsequent COLAs; or applying any benefit recalculation only to the worker's own benefit and not to any dependent benefits based on his earnings record. However, those who currently work and receive Social Security benefits could argue that they are paying payroll taxes on their current earnings and that these earnings should be included in the benefit recalculation if it is to their advantage.

Restrengthening the Earnings Test

The earnings test was originally designed to control program costs by ensuring that only those who lost their earnings because of retirement would receive benefits. However, the earnings test has been relaxed many times over the past 60 years.[56] This relaxation of the earnings test has been very costly to the program. SSA estimates that, in 2000, it will pay about $80 billion to working beneficiaries and their dependents, about 20 percent of the program's estimated total benefit expenditure. This does not mean Social Security benefits would be reduced by $80 billion yearly if a draconian earnings test were reintroduced, however, because many of

[56]Today, there are two annual earnings tests. Those under age 65 can earn $9,120 annually without penalty, after which point benefits are reduced $1 for each $2 of additional earnings. For those aged 65 through 69, the threshold level is $14,500 (rising to $30,000 in 2002), and benefits are reduced $1 for each $3 of additional earnings. Once a person attains age 70, the earnings test no longer applies.

those who currently work and receive benefits would choose to forgo their earnings rather than their benefits.

The earnings test could be strengthened by reducing the threshold at which the test first applies by (1) either increasing the amount Social Security benefits are reduced for each dollar of earnings above the threshold or reducing benefits by a given percentage for each dollar of earnings above the threshold[57] or by (2) increasing the age at which the test no longer applies, perhaps in line with any increase in the NRA.

Disallowing Most "New Dependent" Benefits

Disallowing dependent benefits for those who were not dependents when the beneficiary became entitled to his or her current benefits is another means of controlling the growth in benefits after entitlement. Exceptions might be made for newly born children who were being carried by a pregnant beneficiary or spouse when the beneficiary became entitled to benefits and for dependents who are not yet eligible for auxiliary benefits because they do not yet meet all eligibility requirements, such as age requirements.

Reducing Benefits by Means Testing

Some have suggested reducing program costs by means testing Social Security benefits. To an extent, means testing is already being done via the income tax on benefits and the earnings test. Means testing via these options could be enhanced as discussed earlier in this chapter.

Benefits for some could also be eliminated or reduced further by more traditional means testing, which would act essentially as a tax. Means testing works by determining whether a beneficiary has other income above a specified threshold and then either eliminating the benefit if the "income from other sources" threshold is exceeded (implying an infinite tax rate) or reducing the benefit according to some formula related to how much the other income exceeds the threshold (the formula determines the tax rate, which could be 100 percent or even higher). A means test need not be based on all the non-Social Security income of a beneficiary. Social Security benefits could also be reduced, regardless of the beneficiary's gross income level, if the beneficiary had income from a specified source, such as savings income or a pension—an alternative already being used to reduce the Social Security benefits of many federal, state, and local government workers who receive pension benefits from employment not covered by Social Security.

[57]This would result in all benefits being withheld from all affected beneficiaries once their earnings exceeded the threshold by a given dollar amount. Currently, those with higher benefit levels can earn more income while receiving some benefits than can those with lower benefit entitlements.

But a means-test tax could lead to economic inefficiencies by changing individuals' behavior. For example, if having any other retirement income could cause a reduction in Social Security benefits, some workers might be reluctant to save for retirement, whether through employer pensions, individual savings, or any other means-tested vehicle. Such workers might prefer to spend their earnings before they retired rather than have their saved earnings reduce retirement income they otherwise would have received. Such a reallocation of consumption from the future to the present could reduce our already near-historically-low national saving rate. This type of behavior can be seen when people shift their income, assets, or both to family or other entities so they can qualify for government-provided Medicaid, SSI, or long-term care.

Means testing benefits would eliminate or further reduce Social Security benefits for many higher-earning beneficiaries. But these individuals tend to pay the largest amount of payroll taxes and receive the smallest percentage return on those contributions.[58] Moreover, means testing the benefits of these individuals could undermine their political support for the Social Security program, and their support is essential if Social Security is to maintain its financing and benefit structures.

Advance Funding Within the Current Program Structure

Although Social Security's long-term financing problem could be addressed without significant change to the primarily pay-as-you-go approach currently in use, some have proposed that the solvency problem could be better addressed with greater reliance on advance funding. Two main mechanisms for advance funding exist within Social Security's government-managed structure: advance funding through a buildup of Treasury securities and advance funding through government investments.

Advance Funding Through a Buildup of Treasury Securities

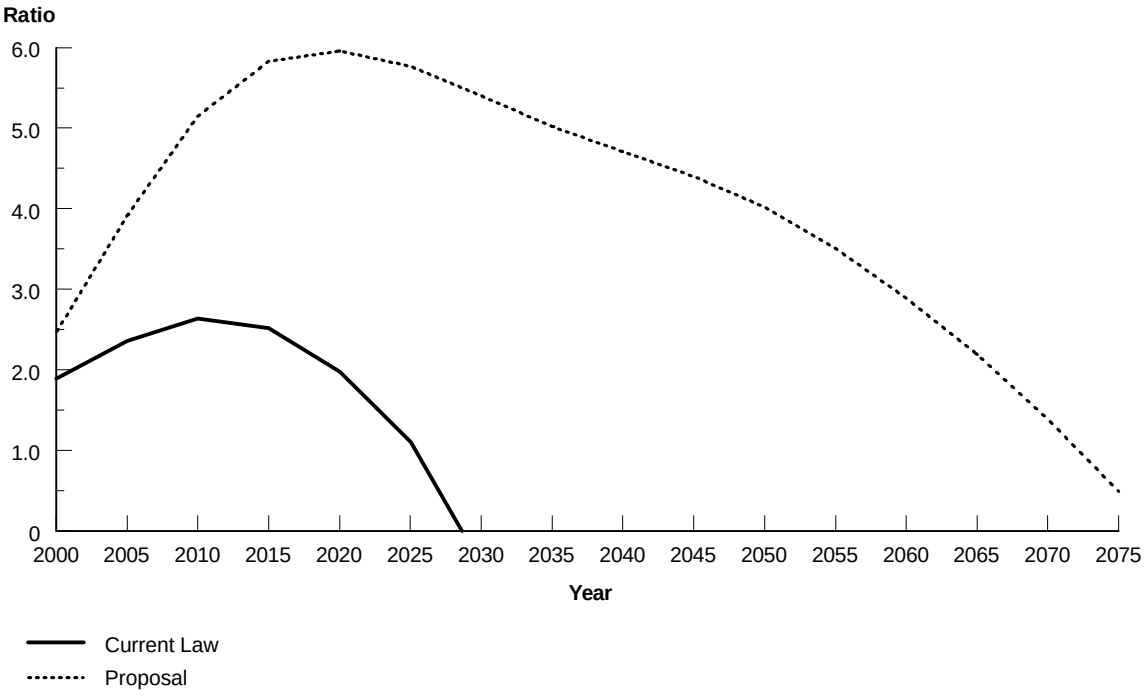
Currently, the Treasury issues its securities to the Trust Funds in exchange for the program's excess revenues. These securities are backed by the U.S. government and have virtually no risk of default. However, they also represent obligations the government issues to itself. From the Social Security Trust Funds' perspective, these securities represent program assets—they signify a reserve budget authority that can be used to meet future benefit obligations. However, from the perspective of the rest of the government, these securities are not assets but claims against the Treasury.

[58]High earners receive the largest monthly benefits, in dollar terms, and tend to live longer than those with lower incomes. Thus, the lifetime returns on their contributions tend to be closer to the returns for workers with lower incomes than Social Security's replacement rate estimates would indicate.

One method of advance funding Social Security would essentially retain the program's current financing, Trust Funds, and benefit structures. Indeed, the current program is already building up a sizeable, but temporary, level of assets that could be used to pay some of the benefits the baby boom generation will need once it retires. The degree of buildup could be enhanced by increasing the program's excess cash revenues through increasing revenues or decreasing expenditures. For example, program revenues could be raised by increasing the total payroll tax by 2.19 percentage points and "investing" all excess revenues in Treasury securities. This change would increase the Trust Funds' buildup and extend the program's solvency by more than 40 years. However, at the end of the 75-year period, the Trust Funds would be expected to contain only about 1 year's worth of benefits.[59] The estimated impact of a 2.19-percent increase in the payroll tax rate on the Trust Funds is compared with the expected impact on the Trust Funds under the current payroll tax rate in figure 3.1.

[59]The 2.19-percentage-point payroll tax increase is projected to keep the program solvent for the next 75 years under the Trustees' intermediate assumptions and, thus, is sufficient to only partially advance fund the program. Fully funding the program would require additional revenues or expenditure cuts.

Figure 3.1: OASDI Trust Funds Assets-to-Expected-Expenditure Ratios Under Current Law and With a 2.19-Percentage-Point Increase in the Payroll Tax Rate Beginning in 1998, 2000-2075



Source: SSA data.

This change would result in higher excess program revenues in the near term and a maximum Trust Funds balance-to-expected-expenditure ratio that would almost double from about 3.2 under the current law to 6.35. But this higher Trust Funds-to-expenditure ratio would present a formidable challenge to future Congresses when they needed to redeem these assets.

Increasing the program's excess revenues and, thus, the amount of Treasury securities held by the Trust Funds could exacerbate the concerns that are voiced today about whether the monies in the Trust Funds are really saved. The Treasury uses the cash received from issuing securities to the Trust Funds to finance other government activities, thereby reducing the Treasury's need to borrow from the public. Some are

concerned that this action both masks the size of the deficit in the non-Social Security component of the federal budget and allows the Congress to spend these Social Security revenues on other programs in the short term without addressing the long-term consequences of this action. Under these conditions, the improvement in Social Security financing would not contribute to increased national saving. It would only allow the Trust Funds to build up more claims against the Treasury without enhancing the nation's future ability to meet these increased claims.

One way that a buildup of Social Security's excess revenues could contribute to national saving would be to use these revenues to buy down the nonfederally held portion of the gross debt (the debt held by the public). This action would not only free up resources and allow them to be used more productively in the private sector of the economy but also reduce the size of future cash interest payments the government would otherwise have to pay.[60]

The resulting enhanced economic growth could increase the size of the future economy and make the government's efforts to collect taxes or borrow to fund future Social Security benefits easier than if the economy had not grown. However, if, after a number of years, Social Security's excess revenues were more than sufficient to pay off the nonfederally held portion of the national debt, then additional productive means of investing these excess revenues would have to be identified.

Advance funding Social Security through increasing purchases of Treasury securities would allow the current, familiar benefit structure to be maintained. Benefits could still be determined using the progressive benefit formula, which provides relatively higher benefits to those with low average lifetime earnings than to those with high average lifetime earnings. The protections beneficiary families now experience through disability, dependent, and survivor benefits could also be retained. Thus, the adequacy focus of the current program could be maintained. However, if benefit cuts were a part of the reform package, the adequacy goal of the program could be weakened.

Advance Funding Through Government Investments

Additional excess revenues created by financing reform could also be invested by the federal government in the private equities market.[61] Such a

[60]Currently, $1 of every $7 of government expenditure is used to pay the interest due on nonfederally held Treasury securities.

[61]See GAO/AIMD/HEHS-98-74, Apr. 22, 1998.

move would have two distinct advantages over using these excess revenues to purchase Treasury securities. First, insofar as Social Security's excess cash revenues were invested in the private equities market, they would not be available to the federal government for other expenditures. Second, these investments could improve the rate of return the Trust Funds earn because, over the long term, investments in equities have historically outperformed investments in Treasury securities.

However, such investments, while offering the opportunity for greater returns, also carry higher risks. For example, equity investments could expose the federal government to the risk associated with asset loss should there be a general market downturn. Should the Trust Funds' equities need to be quickly liquidated to pay benefits, there is no guarantee of the prices they would bring. In contrast, Trust Funds Treasury securities can be readily liquidated, should the need arise, with no uncertainty about their value.

From a federal budget standpoint, investing Trust Funds in the private sector would increase the federal deficit (or reduce the surplus), because the purchase of equities would be counted as an outlay under current budget rules; therefore, the funds used to purchase these equities would no longer be available to the rest of the federal government. If the deficit in the non-Social Security portion of the federal budget was not otherwise eliminated, the government would need to borrow an additional sum, up to the amount of the program's excess revenues, from the public to pay for all its then-current expenditures. However, the increase in the federal deficit that would result from borrowing additional monies from the public would not increase the federal government's debt. The Treasury securities would be held by the public rather than the Trust Funds.

Equity investing by itself would not change the impact of federal finances on national saving if the equity purchases were offset by an equivalent issue of Treasury securities to the public. In the short term, such an asset shuffle could result in higher equity prices and higher interest rates. Even with higher equity prices, however, the returns to equities would generally be expected to remain above the rates of return from investing in Treasury securities. The increase in interest rates would raise interest income from new Treasury securities held in the Trust Funds, but it would also raise future interest expenditures for the non-Social Security component of the federal government.[62]

[62]However, if policymakers reacted to an apparently higher unified deficit by cutting spending or raising taxes, the resulting fiscal improvement could contribute to higher national saving.

Equity investing would necessarily result in additional administrative costs for handling the investments: costs for hiring and training a staff to carry out the daily operations of the organization that oversees these investments, hiring a board and financial advisers to determine how to invest the Trust Funds, hiring fund managers to be responsible for actually investing the funds, and hiring and training staff to carry out certain oversight responsibilities. However, the increase in the government's costs could be manageable because the majority of the operating and administrative needs of such a modified Social Security program are already in place.

Other concerns about government investing in the equities market are that (1) the funds might not be invested with the goal of minimizing risks and maximizing returns; (2) the government might be tempted to steer these investments for politically motivated purposes, such as aiding financially troubled companies or industries or achieving socially desirable purposes; and (3) even if the government did not select an equity portfolio on the basis of political or nonfinancial objectives, the government might be able to affect corporate management decisions by exercising its stock voting rights. To minimize the first and second concerns and to control transactions costs, the government could direct its fund managers to select equities using a broad-based market equity index. However, the third concern would remain unless the government either assigned its stock voting rights to its fund managers or forbade itself from exercising these rights. In this latter case, the power of the voting rights held by the remaining large stockholder groups would be enhanced.

Features and Implications of Individual Account Plans

Most proposals to restore long-term solvency to Social Security include the creation of a system of individual accounts. Some proposals have the government managing the accounts, but others leave it largely to the individual to make the investment decisions. The key question raised by these proposals is how well individuals and households might do if part of their retirement income that now comes from Social Security depended on the performance of their individual accounts. Such a movement to individual accounts involves a trade-off between higher returns and higher risks. Historically, stocks and bonds have yielded higher returns than the implicit return that current workers can expect from Social Security. Nevertheless, consideration should be given to the added risks associated with individual accounts. The Congress would need to decide how the social adequacy goal would continue to be met under such a system and determine how the social insurance elements of the current program, such as disability and survivor benefits, would be provided.

Implementing individual accounts raises other issues as well. Making the transition to advance funded, individual accounts would require some to "pay twice"—once for current beneficiaries' retirement benefits, and once for their own. In addition, major issues, such as whether beneficiaries would be required to annuitize their accounts and what changes would be necessary for administering the program, would need to be addressed. These issues would need attention regardless of whether the accounts were managed by individuals or by the government.

Individual Accounts Invested in Stocks and Bonds Would Likely Generate a Better Rate of Return, Albeit at Some Increased Risk

Individual account systems generally aim to add to the retirement income provided by Social Security. Proponents of individual accounts argue that the returns to payroll taxes have fallen and will continue to do so. Returns in the early years of the program were high because, for adequacy reasons, the benefits received far exceeded what could be justified given the contributions the earliest retirees made to Social Security while they worked. As the program matured and workers spent increasing time in the covered workforce, the high initial benefit subsidies declined as did the implicit rate of return on contributions. At the same time, because average real returns to stocks and bonds are higher than the return from Social Security, individuals have the potential to be better off if their contributions to Social Security are invested in individual accounts. There have been a number of studies aimed at demonstrating the advantages of individual account proposals. The Advisory Council presented, for various individual and household configurations, estimates of the returns on contributions for its three proposals. In general, the estimates suggest that

the PSA plan, which most closely represents the annuity-welfare concept, might provide superior retired worker benefits for many individuals. (See app. II.)

A primary concern in moving to individual account plans is the increased risk to the security of retirement income.[63] Historically, Social Security has offered near certainty regarding benefit receipt. The uncertainty that can surround the amount and lifelong receipt of nonannuity, privately provided retirement income is, in fact, one of the major rationales for public provision of retirement income. Individual accounts introduce elements of market risk and other risks currently borne by the federal government.

Markets are volatile, and, while they can generally be expected to provide better returns than bonds over the long term, they have had periods of substantial downturn that lasted for some years. Pensions hold a majority of their assets in stocks, and even individuals hold substantial amounts of their savings in accounts that are invested in stock market equities—such as IRAs, mutual funds, voluntary 401(k) plans, and so on. Thus, if a significant portion of Social Security income also depended on the market's performance, a broad and long-lasting market downturn could have a negative impact on a large portion of retirement income.

Even if the market experienced no dramatic or long-lasting downturns, the normal market cycles will create "winners" and "losers," depending on when and how workers invest their "Social Security" assets in the market and when they liquidate their holdings. Individuals with similar work histories could receive substantially different benefits. As long as workers are aware of and accept this risk, there will probably not be calls to fix the "unfair benefit outcomes." However, if such large differences in outcomes become commonplace, many participants could become dissatisfied with the program.

[63]This concern raises the questions of whether government should guarantee a minimum benefit from individual account accumulations and whether such a guarantee would encourage greater risk-taking.

Individual Account Proposals Raise Questions About How to Maintain the Goal of Income Adequacy and How to Provide Ancillary Benefits

If individual account proposals were implemented, the question of how to preserve the goal of income adequacy would need to be answered. Many proposals based on the annuity-welfare model seek to minimize the redistributive aspect of Social Security and focus on providing a basic income floor or minimum benefit. Thus, one issue involves determining the appropriate level of "social adequacy" for the social insurance system. Proposals for individual accounts focus primarily on the retirement benefits portion of the program, but the current Social Security system also includes ancillary benefits that may not be easily obtained or duplicated in the private market. It is important, then, to consider how creating individual accounts would affect these other elements of the benefit package—in particular, disability benefits and benefits for dependents (spouses, children, and survivors). Social Security also has important interactions with other retirement income sources: pensions, personal savings, and earnings play substantial roles in determining the level of income that individuals and households will have in retirement.[64]

Level of Social Adequacy Would Need to Be Determined

The annuity-welfare concept of social insurance leads to questioning the appropriate role for the government in providing retirement income. The emphasis under this approach is on separating the annuity part of the program, in which benefits are directly linked to contributions, from the redistributive or welfare part of the program, in which the benefits of the less fortunate are raised to a "more adequate" level. The existing Social Security program embodies the idea that these decisions should be made jointly in the context of a universal program of retirement income (social) insurance. Ascertaining the real difference between these opposing conceptions of social insurance may be difficult, but a key part of the difference relates to the "process" for deciding the relative importance given to the components of redistribution and contributory insurance. While under each of these concepts the political process would sort out the relative importance of the components, the main thrust of the annuity-welfare view is to make the redistributions more explicit—that is, more visible to program participants, voters, and political decisionmakers—than is the case under the existing structure.

While discussions of social adequacy often address the poverty issue, it does not necessarily follow that these discussions determine the level of support that should be provided. The provision for retirement income spans an individual's entire lifetime, and it is particularly important to

[64]Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS-97-81, July 11, 1997).

consider various incentive and efficiency effects of any social adequacy level that is provided. The obvious consideration is that if the safety net benefit level is set too high, then work and savings disincentives could arise, and some workers could be encouraged to "free ride." But if the level is set too low, then some individuals could live out their retirement years in extreme poverty.

Incentive effects are a major rationale for the contributory aspect of Social Security. An individual's benefit must be "earned" by making contributions. In considering the social adequacy level in the context of the program structure, several ideas have been advanced. Some favor a better targeting of the redistributive component through means testing. One idea behind proposals for means testing is that the existing design of Social Security provides benefits to all income groups, and often the redistributive aspect is not well focused on the needy. Advocates for the existing structure of Social Security point out that the program is, in fact, designed to avoid the pitfalls of means testing, which create both stigma and work and savings disincentives for low earners.

Some proponents of the annuity-welfare concept have raised the idea of a flat benefit, or "demogrant." Since everyone would receive the demogrant, many of the work disincentive effects would be minimized, particularly if the demogrant was not set at too high a level. With the demogrant, the redistribution would be addressed in a way that was visible politically. It could even be financed with general revenues. This type of financing would be consistent with strengthening the linkage between contributions and benefits in the annuity part of the program. Also, the demogrant could avoid the stigma that means testing would introduce, since it would go to everyone. The current program and the demogrant approach are similar in their effects, with the major difference being how the decision about the social adequacy level is arrived at in the political process.

The fundamental issue for social insurance, then, is what level of social support society wants to provide to its elderly. Even providing a level of support far below the poverty level is likely to carry substantial cost.[65] Another important aspect is the notion of minimizing the stigma that is usually associated with the receipt of transfers (that is, "welfare").[66] Also, an important consideration that is often overlooked is the role of the SSI program. Depending on the design of reforms, the existing SSI program

[65]Thompson, "The Social Security Reform Debate," 1983.

[66]Thompson, "The Social Security Reform Debate," 1983.

might be expanded to serve more people. Proposals could be devised to include a demogrant, which might absorb the role played by SSI.

Treatment of Ancillary Benefits Would Need to Be Considered

Disability and dependents' benefits are often not included in the discussion of individual accounts because it is, in principle, possible to separate them from retirement benefits. Retirement, disability, and auxiliary benefits, respectively, account for approximately 68.1 percent, 10.5 percent, and 21.4 percent of all benefits paid. Separating the "price components" of the various parts of Social Security would mean that disability and auxiliary benefits could be maintained in the presence of individual accounts for a part of the retirement benefits portion of Social Security. However, it would also imply that the administrative apparatus of Social Security, including the reporting of earnings by employers, would have to be retained.[67]

There is also the question of whether the disability and dependent portions of OASDI could be better provided through private markets. Disability insurance is provided by private insurers and through group insurance arrangements financed by employers. However, a key feature of the benefits provided by Social Security is that they are universal—that is, they are available to everyone regardless of age or occupation. This would generally not be the case with individual disability insurance policies, and even the current employer-provided group arrangements might be subject to certain restrictions.

A voluntary private disability insurance program, combined with insurers who might want to avoid the problem of adverse selection, suggests that comprehensive disability protection would be available to some only at a high price. At the same time, it is difficult to assess how private markets might perform in providing various insurance substitutes given that Social Security today plays such a major role in providing such benefits. If the private sector were to play a larger role in providing disability benefits, it might be necessary to enact laws that require private providers to offer certain benefits or features. An example of this is the recent preexisting condition legislation in the health care area.

While disability benefits would largely be unaffected under the Advisory Council's MB proposal, the IA and PSA proposals reduce these benefits. Under the IA proposal, the essential structure of DI would remain intact,

[67]Administrative expenses for DI are higher than those for OASI. In 1996, OASI expenses were 0.6 percent of benefit payments, and DI expenses were 2.6 percent.

but the benefits for DI beneficiaries would be reduced because individual investment benefits needed to offset the reduction in program benefits would not be available until age 62. DI benefits would also be heavily affected under the PSA proposal and could be reduced by as much as 30 percent from today's DI benefit levels. These DI beneficiaries would not have access to their individual accounts until age 65, the proposed early retirement age under the PSA proposal.

With respect to dependents' benefits, individual account proposals imply reduced spousal benefits. With individual accounts, much of a person's retirement benefit would depend on how well his or her own investments performed. Thus, unless spouses had their own individual accounts, they could be worse off than under current law. Those spouses who would not accumulate substantial assets in individual accounts might be eligible for a reduced spousal benefit or a demogrant. But it is also important to realize that the role of spousal benefits within the existing program structure may be declining in importance because of changes in women's labor force participation.[68]

Survivor benefits would also be affected under proposals to create individual accounts. Currently, when a retired worker dies, the dependent spouse is eligible for a survivor benefit if it is higher than his or her own retired worker benefit. With individual accounts, the survivor could inherit the asset accumulation in the retired worker's individual investment account. These assets could supplement any other Social Security benefits the survivor might receive. However, the deceased worker could also bequeath these assets to others. Even if these assets were left to the surviving spouse, the survivor could have a lower or higher benefit amount than under current law, depending on the survivor's individual circumstances. The IA proposal would lower spousal benefits in order to increase survivor protection for two-earner couples.

Other Retirement Income Sources Could Be Affected

The post-WWII era has seen a general rise in living standards and a substantial evolution in the retirement income system. Social Security has provided the foundation for the retirement living standard of the population and has largely fulfilled its original intent in alleviating elderly poverty. But private pension coverage has also increased and now provides a substantial portion of retirement income for many of today's

[68]For further discussion, see Social Security: Issues Involving Benefit Equity for Working Women (GAO/HEHS-96-55, Apr. 10, 1996); Social Security Reform: Implications for the Financial Well-Being of Women (GAO/T-HEHS-97-112, Apr. 10, 1997); and Social Security Reform: Implications for Women's Retirement Income (GAO/HEHS-98-42, Dec. 31, 1997).

elderly. Increases in home ownership and personal savings have meant greater wealth in retirement for many households. Incorporating individual account features in Social Security would have important implications for the entire framework that provides retirement income to the elderly. The debate over how to resolve Social Security's financing requires recognition of the broader changes that may take place in response to any actions taken. Here we suggest but a few of the issues that might arise.

The existing private pension system has traditionally provided a voluntary, private source of retirement income. Creating individual accounts is essentially aimed at further expanding the role of private institutions in providing retirement income. If this role were expanded, it is hard to imagine that the existing private pension system would not be affected. One obvious change would be in private pension plans' "integration" with Social Security. Currently, some employers agree to provide a benefit that is adjusted by any amount received through Social Security. If Social Security benefits were reduced, then private employers with integrated plans might experience an increase in their pension costs that could prompt them to redesign their plans.[69]

It is also unclear how workers' personal savings behavior might be influenced by a new system involving individual accounts. Economists have long debated various theories of savings behavior in the context of the effects of Social Security. This debate has largely focused on the theory that the promise of Social Security benefits would be viewed by individuals as a form of "social security wealth" that could result in lower saving.[70] This fundamental debate about the behavioral effects of social insurance on personal saving is ongoing although, on balance, the prevalent view is that funded social insurance is more likely to be consistent with higher saving. Much recent research focuses on the effects of individual savings plans, such as IRAs and, particularly, 401(k) plans, and this research may yield useful insight into the possible effects of introducing individual accounts.[71]

[69]The Tax Reform Act of 1986 changed pension plan integration rules. See Geoffrey Kollmann, Ray Schmitt, and Michelle Harman, Effect of Pension Integration Rules on Retirement Benefits, report to the Congress (94-974 EPW) (Washington, D.C.: Congressional Research Service, Dec. 6, 1994).

[70]Martin Feldstein, "Social Security, Induced Retirement and Aggregate Capital Accumulation," Journal of Political Economy, Vol. 82, No. 5 (Sept./Oct. 1974), pp. 905-26.

[71]For example, see 1994-1996 Advisory Council Report, 1997, Vol. II, pp. 41-48.

Finally, individual accounts could affect workers' decisions on when to retire. A number of factors affect an individual's decision to retire. If the age at which a worker becomes eligible for full benefits is further increased, individuals might stay in the workforce longer. If individual accounts fulfill their promise of higher levels of retirement income, then workers may retire early despite the increase in the retirement age.

Making the Transition to Greater Advance Funding Would Pose Funding Challenges

Because by definition individual accounts are advance funded, a significant shift toward such a system would raise transition questions. The practical problem that would occur is that, because most of the benefit obligations of current retirees and workers are unfunded under pay-as-you-go, any diversion of current workers' taxes to fund their own benefits would leave less with which to pay current and accrued retirement benefits. As a result, current workers would need to be asked to "pay twice"—once for the accrued benefits of current and future retirees and again for their own retirement benefits.[72] In subsequent generations, workers would have to pay to fund only their own benefits. Although advance funding is generally associated with individual accounts, advance funding could be introduced without them. The system is already partially advance funded, and government's investing a part of the Trust Funds in the stock market would represent an increase in advance funding.

If the current program was terminated and a new fully advance funded one that included all current and future workers was started, the amount necessary to pay the accrued benefit obligations under the current Social Security system would be about $9 trillion. In principle, transition costs do not pose any greater cost than already exists under Social Security. Concerns about transition costs arise primarily because of the timing of paying for benefit entitlements. Under pay-as-you-go, the costs of paying accrued benefits occur in the future and represent an unfunded promise—a type of implicit debt. In moving to an advance funded system, the future benefits, which would need to be paid for eventually, would be recognized today. Paying these benefits could involve significant payroll tax increases or a sizable increase in government debt.

[72]The original decision to finance the Social Security system on a pay-as-you-go basis was the result of the need to get funds to the elderly and needy quickly, the need to spur the economy, and the fear of a large reserve in government hands. This decision led to the first cohorts of retirees receiving transfers considerably in excess of their contributions. Subsequent cohorts, however, have increasingly "paid" for their benefits but must still depend on future generations of taxpayers to fund them.

Making a transition to an advance funded system would also present political difficulties. Reneging on benefit obligations or requiring current workers to "pay twice" could significantly disadvantage many individuals, and showing that a funded system was superior to pay-as-you-go would do little to ease the pain. It has been suggested that the current pay-as-you-go program has created a "lock-in" effect that was largely intended when the program was designed.[73] That is, transition costs could prevent individuals from supporting a potentially superior alternative that offers higher benefits or returns until the benefits under the existing system become considerably worse than they would be under the alternative.[74] Voters could continue to support the current program structure, which could increase the political costs of making a transition, and the existence of strong interest groups could add further to the political costs and difficulty of making such a transition.

Nonetheless, the problem of "paying twice" could be mitigated in several ways. One way would be to reduce accrued benefits for the current retired generation. The IA plan attempts to address the long-term financing problem, for the most part, by reducing future benefits, including those already accrued, for current workers. Another way to mitigate the economic and political costs of transition for a particular generation of workers would be to push the costs of accrued benefits into the future. This would be similar to what a pay-as-you-go system does. Two ways to avoid putting responsibility for all of the transition costs on one generation of workers would be to levy special taxes on the entire population or to finance the transition through borrowing.[75]

Under the first approach, the accrued obligations of the Social Security system that came due, and that were in excess of the financing available, could be financed by levying an array of taxes. Each type of tax that could be used would have different impacts on individuals and the economy. A payroll tax would be consistent with the current financing of the program, but because of its regressive impact on lower earners, it might not be seen

[73]David V. Bryce and Robert B. Friedland, "Economic Security: An Overview of Social Security," in EBRI, Assessing Social Security Reform Alternatives, 1997, p. 83, note President Franklin D. Roosevelt's famous explanation for his insistence on contributory taxes: "We put those payroll contributions there so as to give contributors a legal, moral, and political right to collect their pension and unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program."

[74]James M. Buchanan, "Social Security Survival: A Public Choice Perspective," Cato Journal, Vol. 3, No. 2 (fall 1983), pp. 339-53.

[75]Note that the three Advisory Council proposals all include an element of partial advance funding and an additional tax to meet these costs.

as desirable. Income taxes could reduce the impact on lower-earning workers and families but could have undesirable effects, such as increasing taxes on savings. Levying taxes to pay the accrued benefits, moreover, could still leave a substantial burden on the current generation of workers.

Another way of financing the accrued obligations in transition to an advance funded system would be to use government borrowing. The government would issue bonds to finance the payment of benefits, and the bonds would be paid off in the future, which would spread the cost to future generations. Because the interest and principle on the bonds would be paid with future taxes, the use of bond financing would be a more effective way of spreading the cost of the transition than taxation. There are a number of ways to implement bond financing. One of the earliest ideas was to issue "recognition bonds," which could be issued to individuals in recognition of the government's intention to honor its benefit obligations.[76] Individuals could redeem the bonds at retirement to provide a retirement benefit.[77]

Individual Account Proposals Would Need to Address Annuitization Issues

Social Security is structured in a way that, upon reaching eligibility, workers receive a monthly benefit—that is, an annuity—for the remainder of their lives. With individual account plans, the worker might be able to choose one of several options for receiving benefits. Depending on the plan design, an individual's account accumulation could be converted to an annuity, taken as a lump sum, left in place, or used for any purpose desired. While this approach offers greater freedom of choice, it also raises several concerns.

One concern is whether the account accumulation would be intended to constitute a source of retirement income as opposed to simply a savings accumulation device that might not be fully used for retirement income. Another concern is the process of annuitization itself. Obtaining annuities individually or on a group basis in the private market could be more costly than having the government provide them. Related to this issue is the question of whether an individual could obtain an annuity that provided features similar to those currently provided by Social Security.

[76]This option was used in privatizing the Chilean system.

[77]One important technical issue could arise in using recognition bonds to finance the transition to a new system. While the concept of an accrued benefit is common to private pension plans, the Social Security system is not designed in a way that workers can easily be "cashed out" when they leave the system. Thus, imputing an accrued Social Security benefit to individuals could be a subject for technical debate.

One of the major goals of proponents of individual account plans is to ensure that individuals have as much freedom as possible in choosing how to allocate their own resources. Individual accounts can offer a large amount of freedom and choice and, in principle, there is no inherent reason why individuals should be required to receive their retirement income through an annuity. Thus, a fundamental issue of retirement income policy is how much the individual's choice should be restricted in order to ensure that he or she does not become a burden on society in old age.

The social insurance approach seeks to provide a "socially adequate" benefit, not a minimal benefit, that protects a substantial portion of the preretirement living standard. This perspective suggests that restricting an individual's choice is justified to achieve a more socially desirable outcome. This perspective is embodied in proposals that restrict the individual to investing through the government and require annuitization of the account accumulations so that there is more certainty that an adequate retirement living standard will be achieved.

An additional complication arises when individual borrowing provisions are considered as a feature of the individual account plans. This is an important issue with private pensions, particularly with 401(k) plans. Restricting borrowing from the accounts helps ensure that the funds constitute retirement income. Allowing borrowing provides more freedom of choice but does not ensure that the accounts will be used for retirement. In this case, the accounts of many might represent more of a tax-deferred saving vehicle than a retirement saving vehicle.[78]

A second major concern is whether those individuals who chose to convert their account accumulations to retirement income by purchasing an annuity would actually be able to do so. One of the major advantages of Social Security is the provision of a lifetime annuity. Private pension plans also provide an advantage because they are able to offer annuities through group arrangements. But those who have an individual account plan might have to obtain annuities in the individual annuity market. While individual annuities are available, they can be costly, especially relative to annuities provided through Social Security. This issue is compounded, since private annuities might not generally contain the same features as a Social Security annuity—features such as dependents' benefits, inflation

[78]401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some (GAO/HEHS-98-5, Oct. 1, 1997).

protection, and the use of unisex life tables (that is, the same assumed mortality rates for both men and women).

It is difficult to predict, however, what would occur if an individual account system were put in place. Some retirees would prefer individual annuities over other payment options, and competition among financial institutions to provide such annuities would ensue. This could be a positive force in driving down the cost of annuities, but the possibility remains that firms would compete for what they perceived to be the best risks, which in this case could be those who are likely to have shorter lifetimes. Competition directed at avoiding adverse selection problems could result in market imperfections wherein certain individuals might not be able to obtain annuities at reasonable cost, and this might lead to calls for legislation or regulation restricting the ability of financial institutions to deny individuals an annuity contract. The government would potentially play some role in either (1) ensuring that insurance markets worked efficiently or (2) continuing to provide annuities when private markets failed to do so.

Individual Account Plans Would Raise Other Implementation and Administration Issues

Implementing individual account plans would raise a number of implementation issues regarding the cost of managing accounts and investments and how to manage financial flows and protect investors.

Costs of Managing Accounts and Investments

Individual account plans would require creating financial accounts for each worker. This would be a huge undertaking, although arguably it should be feasible since existing financial markets and SSA are already able to handle large numbers of individuals and transactions. Nevertheless, depending on the design of the program—whether the accounts were managed by individuals or were managed for them by the government—the scale of new resources required could be large and could imply a significant expansion of the administrative structure of either the current program or investment firms (and employers) in the private sector.

There are significant differences in the relative costs of publicly managed social insurance systems and privately managed individual account arrangements. Social Security is a large, centrally managed public system.

The costs of Social Security were high relative to benefits paid during the early years of the program.[79] As benefit payments have grown, the administrative costs of OASI as a percentage of expenditures has fallen to the rather low 0.6 percent of benefit payments experienced today.

Administrative costs for individual account plans would depend greatly on the specific design. There would be initial costs in setting up the necessary systems. But the experience with Social Security suggests that while moving to an individual account system might involve large start-up costs, the ongoing costs of the system might fall as a percentage of assets as the accounts grew over time. The ongoing costs of an individual account system would involve two major elements: the cost of managing and maintaining the accounts (that is, record keeping costs) and the costs associated with investing funds.

Concerns have been raised about the amount of funds that would be held in the individual accounts and how transaction and administrative costs would affect them.[80] It has been noted that the account balances for many individuals could be quite small and that there could be a large number of rather small transactions. These factors could make it costly for private institutions to maintain the accounts. If the administrative and transaction costs were charged to individual account holders, they could greatly reduce, or even eliminate, any gains small accounts might otherwise receive. This could be one area in which a government-managed individual account plan might have an advantage. The government would be able to collect deposits through the existing payroll tax collection system and perhaps reduce transaction costs.[81] However, it is not certain that the size and number of individual accounts would be a significant problem for the private sector, which already manages 401(k) plans that are similar to the individual account plans proposed.

Another issue concerns the specification of investment alternatives for the accounts. Under a privately managed system of individual accounts, individuals or employers might contract directly with financial institutions. This could mean a wide array of investment choices for individuals and, at the same time, a wide variation in potential financial outcomes. Some

[79]Olivia S. Mitchell, "Administrative Costs in Public and Private Retirement Systems," working paper no. 5734 (Cambridge, Mass.: National Bureau of Economic Research, Aug. 1996).

[80]Robert J. Myers, "Social Security: Myths and Realities," in EBRI, Assessing Social Security Reform Alternatives, 1997.

[81]Mitchell, in "Administrative Costs in Public and Private Retirement Systems," 1996, notes that some of the costs of collecting payroll taxes and subsequent monitoring and enforcement are borne by the IRS and that these costs are not included in the operations of SSA.

individuals might not be familiar with basic investing strategies, and they would have to sift through a potentially large amount of information that financial institutions sent them as they competed for clients. Expanding investment education for workers has been suggested as one way to address this concern. However, who would provide this education is an open question.

As already noted, financial institutions would incur costs in managing the accounts and would charge fees as part of making transactions. Data suggest that administrative expenses are higher in mutual funds that are more actively managed, whereas funds that are more passively managed—such as index funds, which tend to make fewer transactions—have substantially lower costs.[82] The extent to which an individual account system would result in large transaction fees, as has been the experience in the early phases of the Chilean privatized system, is unclear.[83]

In estimating outcomes for the Advisory Council proposals, assumptions were made about relative administrative costs. Both the IA and PSA proposals assume that at least a part of the activities of the current Social Security program would continue after the new advanced funding mechanisms were in place. Thus, much of the costs of the current program would be retained. The proposal that recommended the larger individual accounts was estimated to have new administrative costs that would be considerably higher than more limited individual accounts.[84]

Managing Financial Flows and Protecting Investors

Implementing private account systems would also raise questions about the management of financial flows and how the individual investor might be protected, both of which relate to the role of monitoring and regulation of private account systems.

[82]Mitchell, "Administrative Costs in Public and Private Retirement Systems," 1996, p. 20.

[83]Robert J. Myers, "Chile's Social Security Reform After Ten Years," Benefits Quarterly, Vol. 8, No. 3 (third quarter 1992), p. 56.

[84]The proposal that would result in larger individual accounts is the PSA option, which was assumed to have an administrative expense factor of 1.0 percent for the privatized portion of the proposal alone. Expenses that would continue to be borne by the remaining components of SSA are not included in this figure. Thus, if the expected gross yield on an individual account was 7.0 percent, the expected real yield would be 6.0 percent. The IA option would be managed by the government through SSA. The administrative expense factor assumed for this option was 0.105 percent. Thus, an expected gross yield of 7.0 percent on individual account balances would result in an expected 6.895 percent real yield.

Individual accounts could be maintained under the auspices of the government, and the financial flows would not need to change significantly. Employers could deposit the required contributions directly with the Treasury, and SSA could make the appropriate distributions to the individual accounts. SSA and the Treasury would have to arrange procedures for allocating the funds to accounts.

If the system was run much like the government's Thrift Savings Plan (TSP) for federal workers, the government would contract with a financial institution to manage several funds. However, given the size of the contributions involved, it would probably not be wise or feasible to have only a few institutions manage these assets. Thus, it would probably be the case that the range of institutions and investments would have to be expanded. As the number of financial institutions participating expanded, so would the administrative complexity. Arguably, a system of direct deposits from employers to financial institutions might be feasible and efficient. However, it is unclear whether a private system might still be more costly than funneling the funds through SSA, in part because a centralized operation might more efficiently handle such functions.

Individual account systems could require substantial monitoring, as would any system of financial transactions. For example, transferring funds between employers and financial firms creates opportunities for fraud. Private pension plans are covered under the Employee Retirement Income Security Act of 1974 (ERISA), which provides a broad framework of pension law that includes codification of fiduciary responsibilities for handling pension assets, disclosure to plan participants, and other provisions aimed at protecting workers' benefit rights. It is not currently clear whether individual account plans would need ERISA-like provisions, although many of ERISA's provisions might prove useful in protecting individual account assets.

Certain monitoring and regulatory concerns—such as those regarding the provision of investment advice and financial education for investors—would need to be addressed. Under a government-managed individual account plan, handling the accounts through the Treasury and SSA might require few additions to the current regulatory apparatus. However, under individually managed individual account plans, new or expanded monitoring and regulatory functions might be necessary. These functions would affect the cost of implementing the new individual

account systems. Evidence suggests that regulatory requirements have added significantly to the cost of private pensions.[85,86]

While administrative issues are not necessarily decisive criteria for determining whether a new Social Security system should be implemented, they do represent an important consideration as reforms are debated. Some evidence suggests advantages from a centralized approach based on the Social Security model, but other evidence suggests that relying on individuals and their brokers has advantages in terms of efficiency and service to the participant.[87] This aspect of the reform debate requires careful scrutiny and additional attention.

[85]See Mitchell, "Administrative Costs in Public and Private Retirement Systems," 1996, and Committee for Economic Development, Who Will Pay for Your Retirement? The Looming Crisis (New York: Committee for Economic Development, 1995).

[86]Since individual account systems involve stock ownership, moving to such a system would raise the issue of corporate governance and proxy voting. This could be addressed, however, by allowing investment managers to vote shares subject to certain guidelines and criteria, as is done in the TSP.

[87]Mitchell, "Administrative Costs in Public and Private Retirement Systems," 1996, p. 40.

Changes to the System's Financing Would Have Important Implications for the Federal Budget and the National Economy

Decisions to increase the advance funding of the Social Security system, whether or not accompanied by individual accounts, could have significant consequences for the federal budget. Changes to the status of the federal budget, in turn, could have implications for the level of national saving and future economic growth. Advance funding could be done either through the public or private sector, although advocates of privately held individual accounts believe that funding through private institutions is more likely to lead to capital formation and enhanced economic growth. Regardless of whether the advance funding was done through the public or private sector, the cost of the transition to the new system would need to be addressed, and the way the transition was accomplished could determine the impact of the shift to advance funding on national saving.

Federal Budget Policies Will Influence the Economic Effects of Reform

Social Security's current financing structure and the Trust Funds have important interactions with the federal budget and government finance. The status of the federal budget, in turn, can affect national saving and future economic growth, which could determine the ability of future workers to provide for their own retirements and for beneficiaries.

Social Security Trust Funds Affect the Federal Budget

The Social Security Trust Funds were designed to maintain a short-term contingency reserve, not to provide advance funding for future obligations. Amendments to the Social Security law in 1977 and 1983 have allowed the Trust Funds to accumulate a reserve beyond what is considered necessary to meet contingencies. This reserve, however, is still well below what would be needed for full advance funding. The Trust Funds' excess cash revenues are, by law, invested in U.S. Treasury securities. In effect, these revenues are loaned to the Treasury, reducing the Treasury's need to borrow from other sources to finance non-Social Security federal spending.

The Social Security cash surplus is expected to remain at about $50 billion annually for another decade, after which the surpluses will get smaller. Without changes to current policy, the program's cash surpluses are expected to disappear in 2013. To cover the subsequent annual cash shortfall, the Trust Funds will begin drawing on the Treasury, first relying on its interest income and, eventually, on its assets. This will have a direct and increasingly negative impact on the federal budget. By around 2032, the Trust Funds will be effectively exhausted—at that time, without government action, program revenues will pay only about 75 percent of total benefits.

While the Trust Funds' Treasury securities are assets of the Social Security program, they are also liabilities for the rest of the federal government that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing other federal expenditures. Thus, not only will the government no longer have access to Social Security's surplus, but the need to cover the system's cash shortfall could force difficult budget and tax decisions in the non-Social Security portion of the budget.

The Federal Budget Influences National Saving

The realization that there will be relatively fewer workers in the future to produce the goods and services to support not only themselves, but also a larger number of retirees, has led many to focus on the potential contribution of Social Security financing reform to long-term economic growth. Future national income and output depend on, among other things, the level of capital stock available. Capital accumulation, in turn, depends on national saving that can be used for investment. National saving is composed of personal saving by individuals, business saving (undistributed profits), and government saving. When the government runs deficits, it subtracts from national saving. National saving rates in recent years have been at historically low levels.

A purely pay-as-you-go system has little, if any, direct effect on saving. The current Social Security system is running cash surpluses that reduce the size of the unified budget deficit and, all else being equal, should increase national saving. However, to the degree that the existence of the Social Security surpluses undermines fiscal discipline elsewhere in the budget, the potential positive effect on national saving is mitigated. If the non-Social Security part of the budget were balanced, the buildup in the Trust Funds would mean positive government saving and could result in larger national saving. These resources would be available for investment and could, presumably, enhance economic growth. Moreover, a larger economy could lighten the future burden of maintaining Social Security.[88] Higher rates of economic growth would mean higher real wages and living standards, and future workers, even if they had to pay higher payroll tax rates to maintain benefit levels, would be in a better position to do so.

[88]See H. Aaron, B. Bosworth, and G. Burtless, Can America Afford to Grow Old? Paying for Social Security (Washington, D.C.: The Brookings Institution, 1989) and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, Oct. 22, 1997).

Advance Funding Could Foster National Saving

The economic importance of advance funding is that it could foster saving. These savings would then be available for capital formation. Retirement programs, such as pensions, are essentially savings for long-term capital formation. Pensions transfer the portion of current income that is not consumed today into income that will be consumed in retirement. In an advance funded pension arrangement, the savings put into pension funds provide capital for business investment, and the returns generated accrue both to the businesses that invested the funds and to the individuals saving for their retirement. Thus, the return available to pension savers is related to the real growth of the economy, and pension saving provides an important basis for capital formation and economic growth.[89]

One of the objections to pay-as-you-go financing is that it is mainly a tax-transfer mechanism that extracts resources from current workers and redistributes them to current retirees and has no direct impact on saving.[90] In order for the government to save and contribute to capital formation, it must extract resources from the economy and either invest them productively on its own or use them in a way that frees up other (private) resources for investment.

Advance Funding Through the Public Sector

Should policymakers choose to increase advance funding through the current Social Security program structure, the Trust Funds could continue to invest rising surpluses in Treasury securities. Under such policies, the federal government could use this capital to retire outstanding debt held by the public, thus freeing up resources to be invested in private sector capital, or it could undertake "public investment," such as building or maintaining infrastructures, which could provide economic benefits that improve efficiency in other areas of the economy. Alternatively, Social Security Trust Fund investment policies could be altered to permit investing surplus funds outside the federal government, such as in the stock market. The various uses of surplus Social Security funds could have different impacts on national saving.

[89]The implicit return available to participants under a pay-as-you-go financed plan is also related to the growth of the economy (that is, the growth in the productivity of the workforce (wages) and the growth in population), but this return may differ from that earned by private capital.

[90]Pay-as-you-go financing may have secondary effects on saving. For example, one could compare the overall savings/consumption balance of the income that was taxed to the savings/consumption balance of retirees' use of the income to attain a sense of net impact on saving and the economy. There may be a host of behavioral reactions by individuals and households to any actions associated with financing social insurance programs, whether they are pay-as-you-go or advance funded. For example, coverage under an advance funded pension plan could cause some individuals to save less through other saving vehicles. And under pay-as-you-go Social Security, it has long been theorized that individuals believe they hold "Social Security wealth," which may cause them to save less outside the Social Security program.

Retiring Debt

When the government runs a budget surplus, resources have been taken out of the economy. If these resources were used to retire outstanding public debt, instead of to fund other government programs, some of the resources of investors who had purchased the debt would be freed up. To the extent that these funds were reinvested, the government would have increased private investment, which, in turn, creates the potential for higher economic growth.[91] The ability of the government to retire debt would depend on congressional spending decisions. It is important to note that the annual Social Security surpluses themselves represent only a small fraction of the future unfunded promises of Social Security. To advance fund all these promises would require running much larger annual Social Security surpluses.

Investing in Capital Projects

Increasing public capital investment would require budgetary actions. Actual investments that could contribute to economic growth would have to be identified, and funds for them would have to be allocated in the budget. The traditional concern with public capital investments is that political processes introduce considerations other than purely economic returns into the decision-making process. Some believe such considerations can be used to impart a "social return" to a particular allocation of resources, which many view as highly desirable. However, there is disagreement about this, and others hold that such decisions may be less subject to the discipline of market forces and, hence, undermine rather than enhance economic efficiency and capital formation.

Investing in Private Financial Assets

A third way for the government to engage in capital formation would be to invest the Trust Funds' assets in private securities.[92] This would create the potential for larger Trust Funds, which could then earn higher returns, further improving the program's solvency. The contribution of such a proposal to capital formation would be contingent on a number of factors. If the non-Social Security portion of the unified budget was in deficit, such an action would be unlikely to change national saving. The purchase of stocks could result in an equivalent issue of government bonds to provide substitute financing for the payroll tax revenues that would have been used concurrently to finance government expenditures. The most likely way for this proposal to represent funding that would lead to higher saving and capital formation would be in the context of a budget surplus, particularly one that had arisen from a balanced non-Social Security

[91]In testimony before the Senate Budget Committee, we noted that extended periods of fiscal surplus could increase per-capita gross domestic product significantly in the long term (Budget Issues: Long-Term Fiscal Outlook [GAO/T-AIMD/OCE-98-83, Feb. 25, 1998]).

[92]This approach is treated in greater detail in GAO/AIMD/HEHS-98-74, Apr. 22, 1998.

budget. But even if there were a budget surplus, the proposal would generate only a small portion of the amount necessary to fully advance fund future Social Security benefits. Such a Trust Funds investment proposal would also raise questions about how a large, government-controlled fund would be managed and whether political considerations would be introduced into the management of the funds or the entities in which the funds were invested. Mechanisms could be designed to limit involvement of the political process in allocating investments; however, it would be likely that such involvement could not be completely precluded.

Some Suggest Private Advance Funding Has Advantages

Many analysts believe that advance funding of Social Security would increase the likelihood that the resources contributed to social insurance programs would result in increased capital formation. While conceptually this could occur regardless of whether the funding was done publicly or privately, in practice, there may be important differences between public and private saving and investment decision-making. There is a substantial body of thought that questions the ability of political institutions to ensure that the resources raised through Social Security, in fact, contribute to national saving and capital formation, and some suggest that funding through private institutions or individuals is more likely to lead to increased saving and capital formation than funding through public institutions.

The argument for private funding is essentially based on the notion that private markets allocate capital efficiently. The main motivation underlying private market decisions regarding investment is the generation of profit, or return. The discipline that the profit motive places on markets is key to the efficient allocation of capital. It is generally agreed that well-functioning, efficient markets are fundamental for healthy economic growth.

Proponents of the annuity-welfare model believe that funding through private institutions would enhance the likelihood that resources devoted to providing for retirement income would lead to increased saving. Private saving, especially for retirement, involves legal arrangements that explicitly recognize ownership of, or benefit rights to, contributed resources. In the private pension field, such arrangements are backed by legal fiduciary restrictions and guidelines such as those that attempt to preclude noninvestment uses of saved resources. Advance funding Social Security would require that sufficient resources be allocated to generate a

future expected benefit. Thus, when sufficient resources were allocated in advance and invested efficiently and productively in real assets, the likelihood that these resources would represent saving, contribute to capital formation, and generate economic returns would be maximized. While advance funding of retirement benefits is viewed as having economic advantages over pay-as-you-go financing,[93] the choice between public and private institutions hinges on judgments about both the role of government and the relative weight given to the adequacy and equity goals.

Financing Transition Costs Could Reduce Saving Resulting From Advance Funding Individual Accounts

While increased advance funding of Social Security by the government could potentially have a positive impact on national saving, the impact would depend in part on what happened in the non-Social Security part of the budget. Advance funding through individual accounts could also have a limited initial impact on national saving, depending on how the transition was financed. If the transition was financed through more borrowing from the public, then the impact on national saving would be reduced.

The transition to full advance funding could mean that one generation of workers would face a potentially staggering payroll tax rate.[94] While this might result in an eventual rise in saving, workers' consumption would significantly drop in the near term, which could negatively affect the performance of the economy for a considerable period of time. In addition, accumulating a significantly larger stock of capital could have implications for financial markets, and the prices of securities, the return to capital, or both could be affected. Thus, the advantages of advance funding hinge on the likelihood that the higher saving would result in increased productive investment and future economic growth. If so, long-term increases in the standard of living might be deemed to be worth the disadvantage of reduced consumption in the near term.

[93]Thompson and Upp, in "The Social Insurance Approach and Social Security," 1997, sum up the evidence on saving in the following way: "a number of economists have examined the effect of pay-as-you-go Social Security in the United States on individual saving. On balance, their results do not support the fear that such a system will seriously erode savings and capital formation. On the other hand, studies in this country also suggest that funded pension plans do have a positive effect on savings. National savings may increase by 30 to 40 percent of any increase in the amount of assets being held in pension and other retirement accounts. Taken together, these two results suggest that, in the absence of offsetting changes in government fiscal operations, shifting from a pay-as-you-go Social Security system to an advance funded system would have a positive effect on national savings."

[94]Feldstein and Samwick's recent work shows that the cost of paying for the transition could be considerably smaller than previously thought. See Martin Feldstein and Andrew Samwick, "The Transition Path in Privatizing Social Security," working paper no. 5761 (Cambridge, Mass.: National Bureau of Economic Research, Sept. 1996), and Martin Feldstein, "The Case for Privatization," Foreign Affairs (July/Aug. 1997), pp. 24-38.

Incorporating a lesser degree of advance funding suggests a lower transition cost. As noted in chapter 4, if the current program were terminated and a new fully funded one were started, the amount necessary to pay the accrued benefits of current workers and current beneficiaries would be $9 trillion. These unfinanced costs of the current system are the transition costs of moving to a fully funded system. The question is when, not whether, such costs will be addressed. Alternatives to paying for the full transition now include benefit reductions, tax increases, or borrowing. Extending the period of time over which such costs must be met would spread the burden over several generations.

Observations

Social Security has provided the basis on which most Americans have built their retirement incomes for nearly 60 years. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others. While the economy's recent performance has extended the projected life of the Social Security Trust Funds, there is general agreement that Social Security's revenues eventually will be inadequate to pay all promised benefits. The nation is now engaged in a debate about how best to ensure the long-term solvency of the program. A number of proposals have been put forward and, while they share the goal of restoring solvency, they contain significant differences reflecting alternative perspectives as to the appropriate structure of Social Security in the 21st century. The approach chosen by decisionmakers will affect nearly every American's retirement income and could be critically important to the economic welfare of many, especially those relying on survivor and disability benefits. Moreover, the way we choose to address the financing issue also could have important implications for the long-term performance of the national economy.

Many elements of the debate that surrounded the creation of the program in the 1930s are resurfacing today. The proposals that are being advanced not only address the relatively narrow question of how to restore solvency but also go to the larger question of what role Social Security and the federal government should play in providing retirement income. The proposed reforms all include both individual equity and income adequacy goals, but the balance struck between them differs widely. Today's social and economic environment is very different from what prevailed in the 1930s when Social Security was enacted. Social Security originally was designed to replace a portion of earnings lost because of retirement or unforeseen circumstances. However, Social Security is now viewed by many as the most significant source of retirement income, and for many it is their only source. Because Social Security provides a lifetime annuity that is indexed for inflation, it becomes an increasingly important source as retirees grow older and exhaust other income sources.

Supporters of the existing program argue that Social Security's financing problems could be addressed without changing the current structure of the program. A combination of revenue increases and benefit reductions, similar to those that have been used in the past to preserve solvency, equal to about 2.19 percent of taxable payroll would be sufficient to restore long-term actuarial balance over the next 75 years. In addition, some supporters of maintaining the existing structure propose to invest a

portion of the Social Security Trust Funds in the stock market to improve the flow of revenues. Our analysis shows that there are a number of adjustments that, in combination, could restore long-term balance while leaving the structure basically intact.

Those who seek fundamental changes to the system do not believe that a sustainable solution to the financing problems can be found within the current structure of the program. They argue that any restoration of actuarial balance within the current pay-as-you-go structure will be short-lived, as demographic trends continue to cause future revenues to fall short of future expenditures. Maintaining the current system, they assert, would thus require periodic increases in revenues, reductions in benefits, or both. Those supporting fundamental change generally call for replacing the primarily pay-as-you-go system with one that relies more heavily on advance funding and replacing, at least in part, the centralized Trust Funds with individual accounts that are owned and managed by the program participants. These accounts could be invested in securities that offered the potential for higher rates of return than the implicit rate of return earned on Social Security contributions. Those advocating fundamental changes rely on historical stock market performance to support their view that the increased risks associated with individual accounts are unlikely to outweigh the benefits.

Moving even part of Social Security to individual accounts would raise many questions and challenges. While individual accounts offer the potential benefits of higher returns, they also expose individuals to risks now borne collectively through the government. The nature of these risks and their potential impacts on different groups of individuals, such as low earners, would need to be carefully considered. It would also be important to consider how important ancillary benefits, such as disability and dependents' benefits, would be treated and how other sources of retirement income might be affected under a restructured Social Security program. Moreover, moving to an alternative program structure that included advance funded individual accounts would require a decision regarding how best to finance the transition costs. Funding this transition would require either supplementary taxes on current generations—asking them in effect to "pay twice"—or a substantial increase in government debt. Further, a host of program design, administrative, and oversight issues would need to be addressed. The costs of implementing the new program design and its administrative requirements could offset some of the advantages of higher investment returns associated with individual accounts.

Another key element is the relative impact of different program financing structures on aggregate saving and the national economy. Saving is critical to the economy's long-term growth, and a larger economy in the future would help ease the burden of meeting retirement costs while sustaining rising standards of living. Advocates of moving toward a system of individual accounts argue that such a system would increase the nation's saving rate, although the substantial transition costs associated with these proposals offset the positive effects on saving in the short and medium term, pushing positive economic effects even further into the future. Raising saving is only one of several important goals addressed in Social Security financing reform proposals. But because saving is so important to societal goals, proposals that have the potential to encourage saving should be carefully considered.

While the debate continues over whether the existing system should be maintained or whether fundamental restructuring is desirable, there is broad consensus that action is needed soon to dilute the impact of the changes and to give workers and their families time to adapt to them. Nonetheless, because such action will affect the nation and its economy for years to come, decisions should be made with full knowledge and debate of the trade-offs inherent in each proposed change.

Estimated Effects of Selected Options for Reducing Social Security's 75-Year Actuarial Deficit

Options for maintaining solvency	Estimated improvement in actuarial balance as a percentage of taxable payroll over 75 years
Increasing revenue	
Expanding coverage	
Requiring coverage for state and local workers hired after Dec. 1977	0.22
Raising the payroll tax rate	Varies
Expanding the taxable payroll	
Increasing the maximum taxable earnings level to cover 90% of total earnings	0.48
Including employer-provided group health and life insurance as covered earnings	0.80
Including pension and profit-sharing plans as covered earnings	0.37
Subjecting employer-provided pension and profit-sharing contributions to a 3% payroll tax	0.15
Increasing the income tax on Social Security benefits	
Eliminating current thresholds	0.21
Taxing all benefits that exceed an employer's own contributions	0.15
Crediting tax income currently allocated to the Hospital Insurance (HI) Trust Fund to the Old-Age, Survivors, and Disability Insurance (OASDI) Trust Fund	0.36
Using general revenues	Varies
Earning a higher rate of return on Trust Funds' assets	
Investing 40% of OASDI Trust Funds in equities from 2000 to 2015 at a 7% real return	0.92
Reducing expenditures	
Eliminating or reducing certain spouse, survivor, and child benefits	
Limiting the spouse benefit to one-half the average primary insurance amount (PIA) of retired workers	0.21
Capping survivor benefits at the worker's maximum benefit in the year the individual was widowed	0.01
Eliminating benefits for nondisabled children of retired workers	0.05
Relating benefits of disabled and deceased workers' children to household earnings	0.04
Reducing disabled worker benefits	
Limiting the initial disabled worker benefit to the retired worker benefit available at age 65	0.40
Reducing retired worker benefits	
Increasing the number of years of earnings included in the benefit computation period from 35 to 38	0.28
Reducing each of the three replacement rates by 0.5% between 2020 and 2029	0.29
Indexing benefit formula bend points with either the consumer price index or the annual wage index minus 1 percentage point	1.54
Raising the normal retirement age (NRA) for those born between 1944 and 1954 and indexing the NRA to maintain a constant proportion between the average adult lifetime and the NRA	0.50

(continued)

Options for maintaining solvency	Estimated improvement in actuarial balance as a percentage of taxable payroll over 75 years
Controlling the growth in benefits after entitlement	
Reducing the cost-of-living adjustment (COLA) to equal the annual increase in the consumer price index minus 1 percentage point	1.39
Reducing the COLA to equal the annual increase in the consumer price index minus 0.5 percentage point	0.72
Limiting benefit increases that are based on recomputation of benefits	[a]
Restrengthening the earnings test	[a]
Disallowing most "new dependent" benefits	[a]
Reducing benefits because of other income	[a]

[a]Estimate not available.

Source: SSA.

Estimated Individual Outcomes for the Three Advisory Council Proposals

The following tables summarize selected estimates of outcomes under the three Advisory Council proposals: the maintain benefits (MB), individual accounts (IA), and personal security accounts (PSA) plans. The tables show estimates of three measures: the ratio of benefits to taxes, the internal rates of return, and the benefit replacement rates for single males and couples. The tables also include estimates of outcomes under present law.

Table II.1: Ratio of Present Value of Benefits to Taxes for the Three Advisory Council Proposals

	Current law	MB	IA	PSA
Single male				
Low earner				
Born 1949, aged 22 in 1971	79	79	73	79
Born 1973, aged 22 in 1995	103	103	95	116
Born 1977, aged 22 in 2019	112	110	98	121
Average earner				
Born 1949, aged 22 in 1971	59	59	54	57
Born 1973, aged 22 in 1995	77	77	70	84
Born 1977, aged 22 in 2019	83	81	73	88
Maximum earner				
Born 1949, aged 22 in 1971	43	43	40	43
Born 1973, aged 22 in 1995	51	51	50	66
Born 1977, aged 22 in 2019	55	54	53	71
Married couple				
One average earner				
Born 1949, aged 22 in 1971	123	123	107	109
Born 1973, aged 22 in 1995	151	151	121	127
Born 1977, aged 22 in 2019	159	156	123	128
Two average earners				
Born 1949, aged 22 in 1971	70	70	68	70
Born 1973, aged 22 in 1995	86	86	90	101
Born 1977, aged 22 in 2019	92	90	95	106

Notes: MB = maintain benefits plan, IA = individual accounts plan, and PSA = personal security accounts plan.

Estimates assume a 0.21-percent lower COLA starting in Dec. 1997 with no change in nominal wage or interest.

Source: 1994-1996 Advisory Council Report, 1997, Vol. I, App. II, Tables 3A, 3As, and 3Am, pp. 200, 202, and 203. Estimates prepared by the Office of the Actuary, SSA, on the basis of the intermediate assumptions of the 1995 Trustees Report.

Table II.2: Internal Rates of Return for the Three Advisory Council Proposals

	Current law	MB	IA	PSA
Single male				
Low earner				
Born 1949, aged 22 in 1971	2.43%	2.43%	2.18%	2.40%
Born 1973, aged 22 in 1995	2.51	2.50	2.26	2.95
Born 1977, aged 22 in 2019	2.68	2.61	2.30	3.00
Average earner				
Born 1949, aged 22 in 1971	1.40	1.40	1.14	1.22
Born 1973, aged 22 in 1995	1.48	1.48	1.20	1.77
Born 1977, aged 22 in 2019	1.66	1.59	1.28	1.86
Maximum earner				
Born 1949, aged 22 in 1971	0.19	0.15	–0.07	0.05
Born 1973, aged 22 in 1995	0.07	0.06	0.04	0.85
Born 1977, aged 22 in 2019	0.28	0.19	0.20	1.03
Married couple				
One average earner				
Born 1949, aged 22 in 1971	3.90	3.90	3.47	3.53
Born 1973, aged 22 in 1995	3.78	3.77	3.11	3.32
Born 1977, aged 22 in 2019	3.83	3.78	3.04	3.26
Two average earners				
Born 1949, aged 22 in 1971	2.05	2.05	1.83	1.85
Born 1973, aged 22 in 1995	2.09	2.09	2.09	2.47
Born 1977, aged 22 in 2019	2.23	2.16	2.18	2.55

Notes: MB = maintain benefits plan, IA = individual accounts plan, and PSA = personal security accounts plan.

The internal rate of return is computed as the constant real rate of return that is needed to equate the present value of contributions under a given plan with the present value of benefits received under the plan.

Source: 1994-1996 Advisory Council Report, 1997, Vol. I, App. II, Tables IRR1 and IRR3, pp. 219-21. Estimates prepared by the Office of the Actuary, SSA, on the basis of the intermediate assumptions of the 1995 Trustees Report.

Table II.3: Benefit Replacement Rates for the Three Advisory Council Proposals

	Current law	MB	IA	PSA
Low earners				
Born 1930, aged 65 in 1995	58.2%	58.2%	58.2%	58.2%
Born 1960, aged 65 in 2025	48.7	48.7	49.1	54.9
Born 1990, aged 65 in 2055	48.7	48.7	49.4	60.4
Average earners				
Born 1930, aged 65 in 1995	43.2	43.2	43.2	43.2
Born 1960, aged 65 in 2025	36.2	36.2	35.6	38.0
Born 1990, aged 65 in 2055	36.2	36.2	36.5	41.9
High earners				
Born 1930, aged 65 in 1995	34.2	34.5	34.5	34.5
Born 1960, aged 65 in 2025	29.9	29.9	29.6	31.9
Born 1990, aged 65 in 2055	29.9	29.9	31.0	36.3
Maximum earners				
Born 1930, aged 65 in 1995	23.8	23.8	23.8	23.8
Born 1960, aged 65 in 2025	24.1	24.1	24.5	27.3
Born 1990, aged 65 in 2055	24.0	24.0	26.5	33.2

Notes: MB = maintain benefits plan, IA = individual accounts plan, and PSA = personal security accounts plan.

The replacement rate is the percentage of earnings in the last year of work that is replaced by benefits in the first year. Estimates assume a 0.21-percent lower COLA starting in Dec. 1997 with no change in nominal wage or interest.

Source: 1994-96 Advisory Council Report, 1997, Vol. I, App. II, Tables RR.1 through RR.4, pp. 223-26. Estimates prepared by the Office of the Actuary, SSA, on the basis of the intermediate assumptions of the 1995 Trustees Report.

Comments From the Social Security Administration

SOCIAL SECURITY

Office of the Commissioner

December 15, 1997

Ms. Jane L. Ross
Director, Income Security Issues
United States General Accounting Office
Health, Education, and Human Services Division
Washington, DC 20548

Dear Ms. Ross:

I am writing in response to your request for our comments on the General Accounting Office's proposed report, Social Security: Examining Different Approaches for Addressing Program Solvency (GAO/HEHS-98-33). We appreciate the opportunity to review the report and hope that these comments will prove useful.

We are pleased that the report explains that privatization proposals are based on a different perspective about the role and structure of Social Security. As the report points out, the theoretical concept upon which Social Security is based is fundamentally different from the one in which individual account reform proposals are grounded. Consequently, such proposals represent a significant departure from the traditional Social Security system, the benefits it provides, and the manner in which it provides them. Social Security, as a contributory social insurance system, pools risk and offers protection to American workers and their families against the loss of income due to old age, death, or disability. In contrast, the proposals that would replace Social Security, in whole or in part, with individual accounts require workers and their families to bear more of the risk of such losses on their own.

We commend the GAO for raising not only the essential theoretical difference between social insurance and privatization approaches, but also many of the issues that would arise in implementing individual account plans. However, we are concerned that the report does not consistently articulate this difference. In some instances, the report contrasts the social insurance and annuity-welfare concepts as competing perspectives on the proper structure of Social Security but in others, it seems to include the annuity-welfare model under the broader rubric of social insurance. We have concerns about using the annuity-welfare model to analyze the present Social Security system because, in addition to the negative connotations the word "welfare" holds for many, it is too narrow to capture the full meaning of the adequacy portion of the social insurance compact.

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We are also troubled by the comparison in the report of pay-as-you-go and advance funded systems. We agree that the current mostly pay-as-you-go system has the problems mentioned in the report. However, the report should indicate that advance funded systems are subject to many of the same limitations. Advance funded systems are susceptible to economic recessions and market downturns; adverse demographic trends may depress housing and stock markets when members of the baby-boom generation retire; and individuals may be unable to save sufficiently or may not invest in high-enough yielding assets.

Similarly, we feel that the report could recognize more forcefully that advance funding could be accomplished within a public social security program. An individual-based privately controlled system is not a necessary condition for high internal rates of return. Approaches that would substantially increase advance funding by further building up the trust fund reserves could improve money's worth measures. However, just as with a private advance funded system, a public advance funded system would entail some tradeoffs.

In addition, although the report frequently alludes to risk, we would suggest that it does not sufficiently address the financial risk inherent in an individual account-type system. Investors potentially receive higher returns only by assuming greater risk, a relationship the report does not clearly express. Furthermore, the report does not discuss the fact that, in the context of private sector trends (such as the increasing prevalence of defined contribution plans), individual account proposals render retirement income security as a whole very reliant upon market outcomes and thus, expose retirement security to a more significant degree of risk.

Finally, in order to evaluate properly the array of reform proposals now before the American people, accurate performance measures must be employed. We are concerned that the money's worth measures presented in the report have some limitations that are not fully explained in the report. The measures presented represent the projected experience of stylized composite individuals and couples. These examples may not be fully representative. Given a group of similarly stylized individuals and couples, some will experience better lifetime stock market yields than others. When the distribution of stock market yields, including losses, is properly accounted for, sizeable minorities in each of the stylized categories would receive greater money's worth in a plan such as the Advisory Council's Maintain Benefits (MB) plan than under a privatized plan like the Council's Personal Security Account (PSA) plan.

As the nation begins to consider the form Social Security will take in the next century, thorough and objective analysis will be indispensable in helping the American people to understand the issues before them and to make the tradeoffs necessary to ensure a secure retirement for all. We are certain that, through this report and others to follow, the GAO will contribute immeasurably to that process, just as it has done on so many occasions in the past.

In addition to these general comments, we have a number of technical specific comments on the report, which are being sent under separate cover to staff. If you should have any questions concerning either set of comments, your staff can contact Judy Chesser, the Deputy Commissioner for Legislation and Congressional Affairs, at (202) 358-6030. Again, we appreciate the opportunity to review the report and look forward to the GAO's continued involvement in this vital debate.

Sincerely,

Kenneth S. Apfel
Commissioner
of Social Security

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